PROBLEM BANK IDENTIFICATION, INTERVENTION AND RESOLUTION IN PAPUA NEW GUINEA

by Steven Avel[1]

1. Introduction

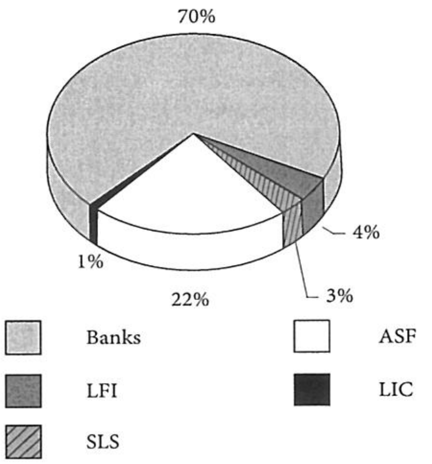
The object of this paper is to present the regulatory and supervisory framework of Papua New Guinea (PNG) and analyse the process of problem bank identification, intervention and resolution in PNG. A former state-owned bank, the Papua New Guinea Banking Corporation (PNGBC), is used as the example to present how the Bank of Papua New Guinea (BPNG) undertakes the processes involved in problem bank identification, intervention and resolution. Details on the PNGBC are attached in Appendices 1a and 1b.

The total assets of PNG's financial system ("system") is valued at K13,754.40 million or US$4,524.47 million (K3.04:$US1) as at 30 June 2007. The system comprises 4 commercial banks with total assets of K9,544.50 million or US$3,139.64 million, 11 licensed financial institutions (K488.20m/US$160.59m), 21 savings and loan societies (K441.6m/US$145.26m), 7 authorised superannuation funds (K3,089.60m/US$1,016.32m), 5 life insurance companies[2] (K190.50m/US$62.66m), 2 investment managers, 5 fund administrators and 3 life insurance brokers.

The banking sector is the critical sector as it holds 69.4 per cent of the system's total assets and the rest by other authorised financial institutions.

Figure 1 below shows the spread of the assets in the financial system.

Figure 1
Financial System's Total Assets as at June 2007



Source: Bank of PNG

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[2] Excludes general insurance companies and brokers which are supervised by the Insurance Commissioner's Office. The National Development Bank and Unit Trusts are not supervised by BPNG.

The distribution above shows that the soundness and stability of the banking sector is crucial in ensuring stability in PNG's financial system. As part of the BPNG's responsibilities, the key aim is to identify and prevent vulnerabilities in the financial system and take appropriate mitigating actions to prevent systemic consequences.

2. Legal Framework for Regulation and Supervision of Financial System

2.1 Legal Framework

Besides the other core responsibilities of formulating and implementing monetary policy and ensuring an efficient payment system, the BPNG is responsible for regulating and supervising all banks and licensed financial institutions operating in PNG. Legislations that mandate the BPNG to perform its functions and responsibilities are the *Central Bank Act, 2000 (CBA) and the Banks and Financial Institutions Act, 2000 (BFIA).* The BPNG is also responsible for the regulation and supervision of savings and loan societies under the *Savings and Loan Societies (Amendment) Act, 1995 (SLSA)*, authorised superannuation funds under the *Superannuation (General Provision) Act, 2000 (SA)* and life insurance companies under the *Life Insurance, Act 2000 (LIA).*

2.2 Coordination and Information Sharing

Under the above laws, the BPNG, in dealing with problem banks and all other financial institutions for which the BPNG is responsible, can solicit the assistance of other agencies, such as the Financial Intelligence Unit (attached to Fraud Squad), Police Department, Registrar of Companies and the CPA PNG Limited (Institute of Accountants). The BPNG takes responsibility for the overall co-ordination of activities.

Although the sharing of information between these agencies is limited, given that the legislations covering the agencies do not allow for sharing of information unless required by a court order, a few government agencies, including the Internal Revenue Commission (IRC) and the Investment Promotion Authority (IPA), have acknowledged the importance of information sharing with the Central Bank and have each signed a Memorandum of Understanding (MOU) with the BPNG.

2.3 Issues on Autonomy, Accountability and Legal Protection of Bank Supervisors

As a result of the reform of the financial system in 2000, bank supervisors have a greater degree of independence in performing their roles and responsibilities without influence or interference from the government or other external agencies. Bank supervisors are also protected under the above five (5) Acts that the BPNG administers. However, there is a greater accountability required of bank supervisors – accountability to the public and to the BPNG in ensuring effective performance of its objectives and functions.

3. Problem Bank Identification

3.1 Supervisory Strategy

Supervision is a preventative and collaborative practice, intended to be flexible and designed to identify and assess risks. The BPNG's approach to supervision is focused on the bank's systems, policies and internal controls. This helps the BPNG to ensure that appropriate procedures are in place to contain risks and, importantly, that the bank's management adheres to them. The objective is to ensure public confidence and a sound and stable financial system.

The supervisory approach used by the BPNG in monitoring the condition of authorised banks is twofold:

i) *On-site examinations or reviews* – which involve the physical presence of the BPNG examiners on a bank's premises to assess a range of activities including: a) the adequacy of management's risk and internal control procedures; b) the bank's systems and processes with regard to the overall operations and condition; c) key ratios, factors and conditions affecting capital; d) the interrelationships between capital and other components of CAMELS[3]; and e) the bank's adherence to laws and regulations and to the terms stipulated in the banking licence.

ii) *Off-site surveillance* – which involve collecting, reviewing and analysing reports and statistical returns. Information used for the analyses are collected through standardized Call Reports submitted to the Financial System Supervision Department (FSSD) on a quarterly basis, monthly reports to Monetary Policy Unit (MPU) and daily market reports to Financial Market Department (FMD). Other sources of information used for off-site monitoring are annual accounts, correspondences and any other publicly-available information provided by the market. Call Reports are also used to check adherence to prudential requirements.

Off-site monitoring is often used to identify potential problems, particularly in the intervals between on-site visits, thereby providing early detection and prompting corrective actions before problems become serious.

From on-site examinations and quarterly off-site reviews, a rating is given to a bank using the CAMELS rating system. Under CAMELS, a bank is assigned a composite rating between 1 and 5 on a numerical scale based on the evaluation and rating of six essential components of an institution's financial condition and operations.

The BPNG also uses CAMELS to categorise institutions with deficiencies in a particular component and to identify problematic financial institutions. In order to do that, the BPNG has set prudential requirements for all components under CAMELS.

[3] CAMELS - The component factors address the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings, the adequacy of Liquidity, and Sensitivity to market risk. It is a rating system used by the BPNG to evaluate the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

3.2 Prudential Requirements

In line with international practices, the BPNG as the regulator and supervisor has implemented all of the 25 basic principles of the Basel Committee on effective banking supervision. These principles provide the basis for the BPNG to strengthen its current supervisory regime.

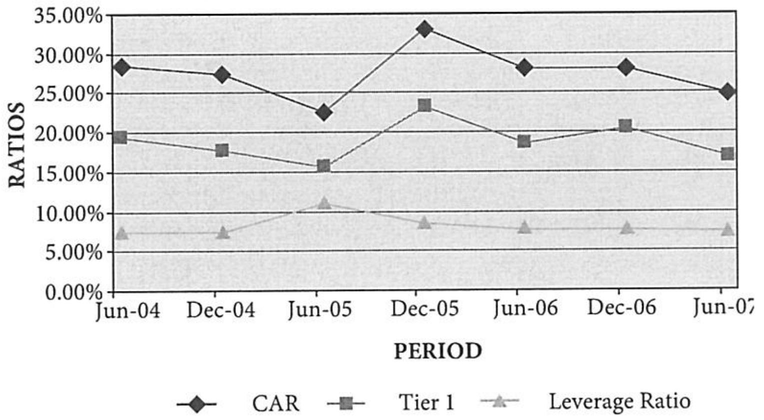
The Financial Sector Reforms adopted in 2000 played a major role in enhancing the performance of banks and financial institutions in PNG. Legislative amendments were made to a number of statutes including the BFIA, setting the framework under which banks and other institutions are supervised. The BPNG has the prudential powers under the BFIA to implement the principles, including setting prudential standards and requirements for banks.

The prudential guidelines include requirements on: (i) minimum capital (CAR 12 percent, Tier 1 Ratio 8 percent, Leverage Ratio 6 percent); (ii) asset classification and provisioning; (iii) limits on Inter-Bank Placements; (iv) limits on foreign currency exposures; and (v) limits on loans to related parties. With the responsibility entrusted to the bank boards to perform and ensure sound operations, the BPNG also put in place requirements to assess the fit and properness of persons holding or intending to hold management positions. Similarly, key performance indicators on earnings are used to monitor performance, while the banks are expected to maintain adequate liquidity for their operations.

These prudential requirements are essential for prudent supervision without which supervision would be difficult to perform. They can also have some positive impact in the growth of bank assets through sound management and adequate risk- management systems to mitigate risks.

Overall, banks have continued to maintain adequate capital relative to risks within the banking sector. Figure 2 below shows the movements in the capital ratios since 2004.

Figure 2
Capital Ratios of Banks since June 2004



Source: Bank of PNG

3.3 Early Warning Systems, Other Indicators and Risk Assessments

Early warning systems and monitoring tools are essential in bank supervision. The BPNG uses CAMELS as an internal supervisory tool for evaluating the soundness of financial institutions and for identifying those institutions requiring special supervisory attention. Non-compliance with the prudential requirements is a cause for concern. Supervisors also use quarterly and annual reports to identify trends in banks that may signal a potential problem.

Information from these reports helps the BPNG monitor activities and trends in key indicators and plan future examination activities and the scope of those activities. Red flags in problem banks take many forms, and BPNG would consider a number of factors before determining the most appropriate supervisory response. The BPNG recognises as red flags in the early detection of potential problems with a particular bank the following:

a) *Asset Quality Deterioration* – is the most common financial risk in nearly all problem banks. This can be caused by economic factors, poor management, anxiety for earnings, insider abuse and other factors.

b) *Adverse Effects of Rapid Growth*
- Capital levels declining rapidly
- Growth varies significantly from the bank's budget or strategic plan
- New products and activities are being pursued with no expertise or inadequate risk-management controls

c) *Management Oversight Deficiencies*
- Non-responsive management
- Passive or uniform board of directors
- On-going noncompliance with regulatory requirements, laws or internal standards
- Insufficient planning and response to risks
- Inadequate talent and experience at the CEO and management levels

d) *Inappropriate Limits on Access to Bank Staff and Documents*
- Refusal to provide information within a reasonable time period
- Blocking access to relevant third-party records
- Providing incomplete and inaccurate information

e) *Risk Management Deficiencies (Policies, Processes, Personnel, Controls)*
- Sound risk-management systems to mitigate risk assumed by a bank.

f) *Strained Liquidity*
- Low liquidity levels
- Decline in deposit levels
- Funding mismatches
- Higher cost of funds relative to market

g) *Insider Abuse and Fraud*

- Extension of credit granted on a more favorable term
- Excessive salaries, bonuses and fees relative to the size of the bank
- Fees paid for services not yet received
- Dishonest or fraudulent act
- Profiting from insider knowledge, etc.

The above can be assessed off-site using the data provided in the Call Reports and during on-site examinations. Indicators from off-site assessment are increasing levels of past due loans and Non-Performing Loans as a percentage of total loans and significant changes in provisions for loan losses. Figure 3 is an example of the type of analysis supervisors performed on reports submitted to the BPNG. These ratios are compared against the benchmarks in place to determine the quality of the loan portfolio.

Figure 3
Asset Quality - Banking Sector

	Jun-07	Dec-06	Jun-06	Dec-05	Jun-05	Dec-04	Jun-04
NPL/Total Loans	2.3%	2.5%	2.6%	3.8%	4.4%	4.1%	5.4%
Provisions/Total Loans	2.6%	2.9%	2.8%	3.5%	4.7%	5.0%	4.2%
Provisions/NPLs	111.2%	115.0%	110.5%	91.4%	106.9%	111.5%	77.8%

Source: Bank of PNG

Deteriorating asset quality is caused by a combination of factors including high loan concentrations, in adequate management information system (MIS), large volume of loans with structural weaknesses and large volume of unsecured lending.

3.4 Communication Concerns

The BPNG recognises that effective, accurate and frequent communication with the board and management is extremely important in problem-bank supervision. It also recognises the value in communicating concerns with other regulators on matters concerning problem banks. The manner in which concerns are communicated to the bank should be clearly defined, and reflect the severity of the given situation. The commonly used methods of communicating concerns to problem banks are:

- discuss the matter over the phone followed by a letter or email confirming the matters discussed;
- conduct exit meetings at the conclusion of an examination or review with senior management and, in some cases, with directors, to summarize the conclusions, required corrective actions and plan for follow-up actions by the BPNG, including formal enforcement actions, if any;
- communicate through the ROE – this is a formal communication of supervisory concerns to a bank;
- conduct meetings with the board whenever there is material information to convey; and
- communicate the concerns to other regulators, e.g. IRC, Insurance Commissioner, Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC).

3.5 Problem Bank Identification: The Case of PNGBC

The process taken to identify the PNGBC as a problem bank is summarised in Appendix 1a and discussed in detail in Appendix 1b.

4. Problem Bank Intervention

4.1 Prompt Corrective Actions

In determining the appropriate corrective actions, the BPNG takes into consideration the severity of the problem and the most appropriate supervisory and enforcement action to take. The type of action chosen depended also on the bank's current condition with consideration given to the cooperation, responsiveness, and capability of the board and management.

Supervisory and enforcement actions that BPNG may take on a problem bank include: (i) issue letter of commitment; (ii) impose additional conditions on a bank's licence; (iii) signing of MOU; (iv) removal of board and or management; (v) sanctions on certain business activities; and (vi) instituting a statutory manager to run the affairs of the bank.

4.2 Resolving Liquidity Problems

Liquidity levels with banks in PNG continue to be high. However, the BPNG requires all banks to have a policy detailing what, how and where to obtain cash for operations at a reasonable cost when needed. It must also have effective processes in place to monitor and react to the contraction of deposits and other funding.

A prudential standard on minimum liquidity will soon be released, outlining the prudential liquidity requirements for all banks. The standard prescribes the level of liquidity a bank should have based on its capital and the quality of assets. This standard will also replace the Minimum Liquid Asset Ratio (MLAR) which is used as a monetary policy instrument.

4.3 Resolving Credit and Capital Impairment Problems

Lending activity is predominately the source of income and financial risk to banks. Thus, the potential for loss in the event of default is imminent. Banks classify and make provisions on all loans under the following categories: Pass (0 – 30 days) – 1 percent, Special Mention (31 – 90 days) – 5 percent, Substandard (91 – 180 days) – 25 percent, Doubtful (181 – 360 days) – 50 percent and Loss (> 360 days) – 100 per cent. These provisions are prescribed in the standard on asset classification and provisioning. During reviews, bank supervisors check to ensure that correct and adequate provisioning is made for loans.

In a situation where a bank experiences capital impairment, the BPNG can impose sanctions such as no dividend payment to shareholders, no major capital expenditures and selling of assets. The BPNG can ask the bank to raise additional capital through injection by the bank holding company or shareholders or through new share issues to the public.

BPNG has set minimum capital requirements of CAR at 12 percent, Tier 1 Ratio 8 percent and Leverage Ratio 6 percent. However, it also has the authority to require more capital in a bank with significant risk.

4.4 Removing Bank Management and Ownership Issues

If the problem relates to mismanagement, then necessary steps can be taken to replace management. For ownership issues, divestment of shares is one option a bank could take to dilute majority shareholding.

4.5 Role of the Courts in Bank Intervention

When all avenues have been exhausted and the aggrieved party is not satisfied with the actions taken, the matter can be put before the courts to decide. The BPNG does not have an in-house legal counsel; therefore, it uses private law firms to take up any litigation cases in the courts on its behalf.

4.6 Problem Bank Intervention: The Case of PNGBC

Following the identification of the PNGBC's problems, the BPNG intervened to save the bank from total collapse and possible disruptions to the financial system. Details of the BPNG's intervention process are shown in Appendix 1a and discussed in Appendix 1b.

5. Problem Bank Resolution

5.1 Grounds for Receivership and Early Resolution

The BPNG has the power and responsibility to appoint a receiver for a problem bank. Under Section 36 of the BFIA, the BPNG may take control of the business of an Authorised Institution (AI) or appoint an Administrator to take over control of the business of an AI where:

(a) the AI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or
(b) the BPNG considers that the AI is likely to become unable to meet its obligations or is about to suspend payment; or
(c) the AI becomes unable to meet its obligations or suspends payment; or
(d) the AI fails to implement or observe, or is breach of, a prudential standard or a condition imposed on its licence such that, in the opinion of BPNG, the interests of the depositors of the AI are materially threatened.

Section 37 of BFIA makes provisions for the basis of terminating control where it empowers the BPNG or the appointed Administrator to take control of the business of an AI until:

(i) the deposits of the AI have been repaid or the BPNG is satisfied that suitable provision has been made for their repayment; or
(ii) the BPNG considers that it is no longer necessary for it or the appointed Administrator to remain in control of the business of the AI.

5.2 Supervisory Responsibilities for Failing Banks

The BPNG does not have a specific office or unit responsible for supervising the resolution of critical problem banks. Institutions experiencing significant problems are handled by assigned analysts who are also desk officers and an assigned senior analyst as overseer. Together with the manager responsible, they will plan supervisory activities, including the development of an on-going strategy, off-site reviews, and prepare various enforcement actions.

Depending on the action to be taken, a legal counsel can be engaged to assist with the matter. The supervision of a problem bank is a time-intensive process, and often in PNG it can take long to resolve. The problem bank is placed under on-going supervision, which includes liquidity monitoring and regular review of the bank's financial movements in the balance sheet or of further depletion of capital levels.

5.3 Asset Quality and Financial Review Process

The PNGBC was the only problem bank that experienced deteriorating asset quality as a result of poor management of its loan portfolio. The quality of assets was critical enough to deplete the bank's capital as shown in Figure 4.

Figure 4
Capital of the Problem Bank

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98	Dec-97	Jun-97
Minimum Req'ment	10.0%	10.0%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
CAR	5.98%	5.04%	8.01%	15.93%	14.50%	8.7%	4.86%	7.89%	12.40%

Source: Bank of PNG

Further, there were records of significant write-offs and inadequate provisioning or allowance for loans and leases.

Figure 5 below indicates that non-performing loans ranged from 18 percent o 25 percent of total loans. This is considered very high indicating poor credit management.

Figure 5
Asset Quality of PNGBC

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98
NPL/Total Loans	21%	23%	22%	23%	18%	25%	24%
Prov/NPL	79%	70%	49%	80%	104%	79%	78%

Source: Bank of PNG

5.4 Bank Closing Process

By the late 1990s, the PNGBC was undercapitalised and it was evident that the safety of depositors' funds was at stake. As the largest bank with a total asset base at K1 billion (US$320m), it was evident that any closure would affect other institutions, thus, creating a systemic risk to the whole financial system.

The decision to sell the bank was made by the government of PNG as part of its privatisation program. The process to expedite the sale was a detailed one, with all parties involved. The PNGBC was successfully sold off in 2002.

5.5 Resolution Methods

There are several methods for resolving failing banks: (i) closure of the bank: deposit payoff; (ii) purchase and assumptions transactions; (iii) open bank assistance; (iv) public/ radical restructuring and (v) mergers and acquisitions.

5.6 Problem Bank Resolution: The Case of the PNGBC

The problems of the PNGBC were resolved through a successful merger and acquisition as illustrated in Appendix 1a and further explained in Appendix 1b.

6. Crisis Management

6.1 Key Policies in Dealing with Systemic Banking Crisis

The BPNG did not have at the time of the PNGBC crisis any documented policies detailing how to deal with a bank in crisis. Despite this, the BPNG has a very good working relationship with other relevant agencies that could assist the BPNG to institute legal action against institutions who fail to comply with the BFIA and the licensing requirements.

The BPNG, as the Central Bank, is also the lender of last resort. This lending facility is provided for banks that are solvent but may have been faced with a critical liquidity problem. So far, BPNG has not directly used this facility to assist a problem bank because PNG has yet to experience a bank failure. However, where there is a critical problem with a particular bank, BPNG would work very closely with the concerned bank to resolve the matter, in order to prevent a systemic crisis.

6.2 Institutional Arrangements for Systemic Banking Crisis

As much as possible the BPNG sees to it that there is a continuous dialogue between the problem bank's board and management to ensure that minimal disruption is caused on its normal operation and there is no systemic risk. In the supervision history of the BPNG, it has been successful in preventing a systemic banking crisis. Nevertheless, with increased reliance on the banking sector for all financial needs, arrangements amongst institutions, particularly the regulated institutions and other regulators, need to be instituted to prevent bank crisis or failures.

6.3 Key Issues in Crisis Management

All banks are required to plan for any "worse case scenario" and have in place a contingency plan. A business continuity plan should be also put in place to ensure its banking business is not disrupted. Bank management must understand the seriousness of the need to plan for future problems.

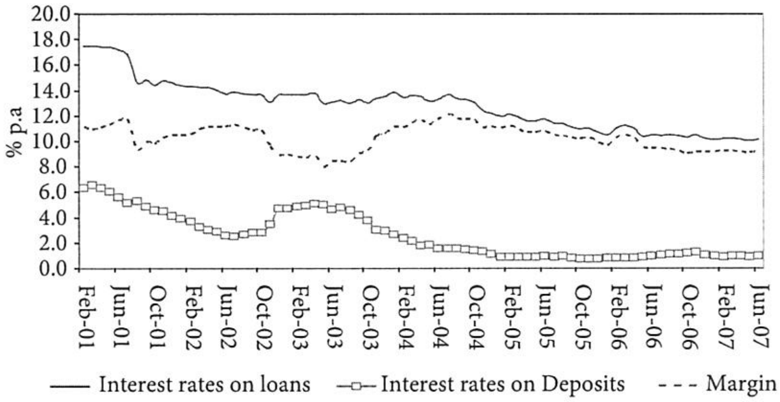
All banks should review and assess the sources of risks in their own business and conduct an audit of areas or provide contingency plans for possible events that can lead to a crisis. In this way, institutions could determine which potential crisis can be avoided by planning for appropriate measures to take and determining the resources to allocate to these areas.

7. Prospects and Future Outlook for PNG's Financial Sector

The financial sector reforms which commenced in 2000 and other structural reforms contributed to the country's favourable economic conditions since 2002. Economic activity continues to grow with renewed confidence by the business community in the government's macroeconomic management. All the major macroeconomic indicators show this positive outlook. These include rising employment levels, increased exports, higher credit growth in the banking system, and prudent fiscal management. These developments have created an enabling environment for the BPNG to conduct monetary policy and achieve price stability. The BPNG has achieved and maintained low inflation, a stable exchange rate and low interest rates. Foreign reserves reached a historic level of US$2,117.50 million (equal to approx. K5,890.20 million) as at 26 November 2007.

Figure 6 below shows a five-year monthly weighted average lending and deposits rates and the margins of commercial banks up to June 2007.

Figure 6
Monthly Weighted Average Lending and Deposits Rates and Margin (spread)



Source: Bank of PNG

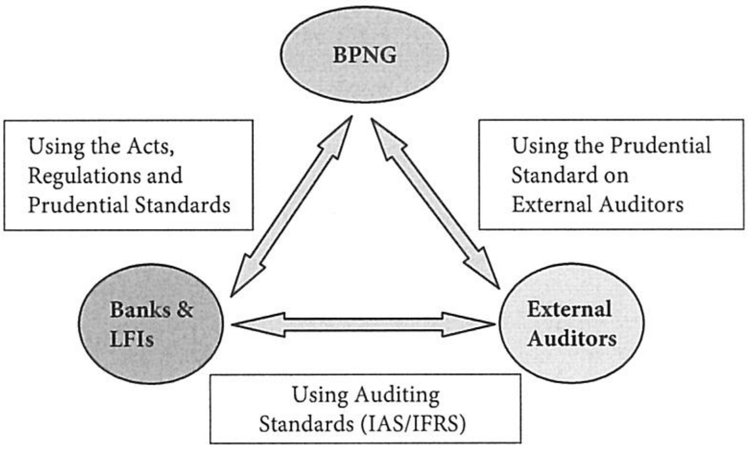
Although PNG's financial sector is strengthened by these favourable economic conditions, the BPNG has to be vigilant in its supervisory responsibilities to ensure the stability of the system and the soundness of the institutions that it regulates and supervises.

It is prudent for the BPNG to be aware of the strengths as well as perceived weaknesses, threats and challenges that may undermine continued growth and sustainability of the financial sector.

7.1 Strengths and Perceived Vulnerabilities of the Financial Sector

The government's decision to reform the financial sector was the significant factor that laid the foundation in building the strength of PNG's financial sector. The passing of the CBA and BFIA gave the Central Bank a focused set of objectives, increased its independence and improved regulation and supervision of the financial system. The CBA also limited the government's access to Central Bank financing and introduced a new Board with wider community representation. Stringent 'fit and proper' criteria were introduced in the BFIA for managers and directors of banks and financial institutions. Strong supervision by the BPNG and the external auditors provided the impetus to growth and strengthen the tripartite partnership in the supervision process.

Figure 7
Tripartite Supervisory Process



A variant structure, but with the similar approach/methodology of regulation and supervision, also applies to the superannuation and life insurance industries following the passing of the SA and LIA in late 2000.

There are perceived vulnerabilities or weaknesses that the BPNG must address which include:

- lack of competition due to few major banks and limited licensed financial institutions;
- limited domestic investment options to invest liquid funds;

- lack of or inadequate prosecution powers of BPNG in the current Acts; and
- penalties in the current Acts are not prescriptive

Weaknesses in FSSD include:

- Department is relatively too large
- High staff turnover
- Department needs to build its staff capacity to strengthen technical expertise in banking, superannuation and insurance; and
- Ineffective enforcement due to inadequate prosecution powers of the BPNG.

7.2 Threats and Challenges to Growth and Sustainability of the Financial Sector

Financial sector growth and sustainability cannot be achieved alone by the government undertaking major legislative reforms or the Central Bank formulating and implementing sound monetary policy and carrying out an effective supervision of the financial system.

Threats and challenges for the BPNG are many. Among them and equally important is the need to adopt and implement good governance in the financial sector. Good corporate governance is important to enhancing strong reporting system, efficient internal controls and risk-management systems.

PNG has an open economy and events and developments elsewhere in the world have a direct impact on the domestic economy and, hence, on its financial sector due to its reliance on the export of its many natural resources. The current favourable economic condition is, to a greater extent, due to the high world prices of these resources, particularly oil and other mineral resources. Significant threats and challenges will come when the opposite scenario becomes a reality for PNG to face. This will present a much greater challenge for the BPNG in its supervisory responsibilities.

7.3 Future Plans

The immediate plan for the BPNG is the restructure of FSSD. The restructure is expected to result in having two Departments reporting to the Deputy Governor, Policy and Regulations. Based on grouping by related industries, the two new Departments would be the Banking Supervision Department (BSD) and the Superannuation and Insurance Supervision Department (SISD). This change is necessary in view of: (i) the FSSD taking on additional responsibilities; (ii) the possibility that the BPNG will regulate and supervise the general insurance industry; and (iii) ensuring greater focus on the industries that are currently paying or prepared to pay the cost of supervision.

For the longer term, the BPNG will review the current legislations to tighten up any loop holes and make adequate provisions for issues, such as penalties for breaches, prosecution powers, cross-border supervision, cost of supervision and a review of the current 'fit and proper' requirements to include minority shareholders.

8. Conclusion

The effectiveness of a Central Bank in dealing with a problem bank is determined by a number of critical factors. These include having an effective legal framework that empowers a Central Bank to carry out its core functions and responsibilities without undue influence or interference from the government, other institutions of government and external agencies. In PNG, the financial sector reforms undertaken in 2000 had paved the way for the BPNG to ensure banks comply with the prudential requirements introduced as part of the reform process. The BPNG also sought external assistance from the IMF and APRA to carry out the reform.

Further, a number of financial institutions, savings and loan societies, superannuation funds and life insurance companies have had to introduce major changes in their structure and business operations to comply with the prudential requirements. These changes, which conform to the Basel Core Principles of Effective Banking Supervision, have realised significant benefits for these institutions and their members/policy holders.

Although these positive developments are continuing, the BPNG will continue to be vigilant in overseeing the performance of all banks, licensed financial institutions, savings and loan societies, superannuation funds, life insurance companies and the general insurance companies in the future. The BPNG is now in the initial stages of restructuring the FSSD as part of its continuing efforts to strengthen its supervisory role and to ensure the financial system remains stable and strong. This calls for equally greater responsibility on the managers and directors of all licensed financial institutions to prudently manage these institutions and to avoid the problems experienced by the PNGBC – the problem bank used in our case study.

The PNGBC, the largest commercial bank owned by the government with an extensive network in PNG and significant market share, and whose profitability was on the decline as a result of its inefficiencies in managing its loan book and bad management practices, was sold to another commercial bank. Although profitability of the bank improved in 1998, this was not sufficient to resurrect the troubled bank as the government had made a decision to privatise it.

As the PNGBC was a wholly state-owned bank, political pressures for loan approvals marred the bank's lending processes. Loan proposals were pushed from two fronts - pressure from national leaders and from the PNGBC CEO level. At the operational level of the PNGBC, loan officers tended to support or favour loan proposals from relatives and business associates. The end result was deterioration in the quality of loans resulting in high non-performing loans and poor earnings. Continuing losses diminished capital; thereby breaching the prudential limits.

The BPNG took corrective actions to rehabilitate the problem bank, and the best option acceptable to all parties was for the sale of the PNGBC to the BSP in 2002.

9. Recommendations

There are many supervisory issues and challenges that the BPNG is faced with. Some of these are discussed in this report. A number of these issues and challenges have been addressed. However, the following recommendations require immediate attention and action to enhance capacity-building and to lift supervision of the LFIs to another level higher:

(i) Following the restructure of the FSSD, which will commence in the first quarter of 2008, the proposed two Departments, namely, the Banking Supervision Department and the Superannuation & Insurance Supervision Department, should start the process to shift away from the current approach, which is based largely on CAMELS, to a more dynamic, forward-looking risk-based supervision approach.

(ii) While a review of the SLSA is underway, a review of the BFIA and LIA should be considered necessary in view of the need to address a number of emerging issues confronting the BPNG, including:
- enforcement and compliance issues;
- prescriptive powers of the BPNG;
- penalties for breaches;
- fit and propriety of shareholders;
- cost of supervision;
- user-pay policy;
- consolidated supervision;
- cross-border supervision; and
- possible inclusion of the general insurance sector under the supervision of the Central Bank.

(iii) There is a need to develop a structured and coordinated approach to ensuring continuous application of knowledge, skills and information received from international training, such as from SEACEN, APRA, PFTAC, etc., to improve the effectiveness of supervision.

(iv) Given that supervisory issues, threats and challenges of SEACEN member countries are not necessarily the same in nature and magnitude, a forum or a similar avenue should be created for the member countries to share information whereby bank problems and solutions can be shared electronically on a web-page or as an agenda on annual meetings of heads of supervisors.

Abbreviations

APRA	Australian Prudential Regulation Authority
ASF	Authorised Superannuation Funds
ASIC	Australian Securities and Investments Commission
BFIA	Banks and Financial Institutions Act, 2000
BPNG	Bank of Papua New Guinea
BSP	Bank South Pacific Limited
CAR	Capital Adequacy Ratio
CBA	Central Banking Act, 2000
FMD	Financial Markets Department
FPG	Financial Pacific Group
FSSD	Financial System Supervision Department
GoPNG	Government of Papua New Guinea
IMF	International Monetary Fund
IPA	Investment Promotion Authority
IRC	Internal Revenue Commission
LFI	Licensed Financial Institution
LIA	Life Insurance Act, 2000
LIC	Life Insurance Companies
MLAR	Minimum Liquid Asset Ratio
MVIL	Motor Vehicle Insurance Limited
NFL	Nambawan Finance Limited
PFTAC	Pacific Financial Technical Assistance Centre
PNGBC	Papua New Guinea Banking Corporation
PwC	Price WaterHouse Coopers
ROE	Report of Examination
SA	Superannuation (General Provisions) Act, 2000
SEACEN	South East Asian Central Banks
SLS	Savings and Loan Societies
SLSA	Savings & Loan Societies (Amendment) Act, 1995

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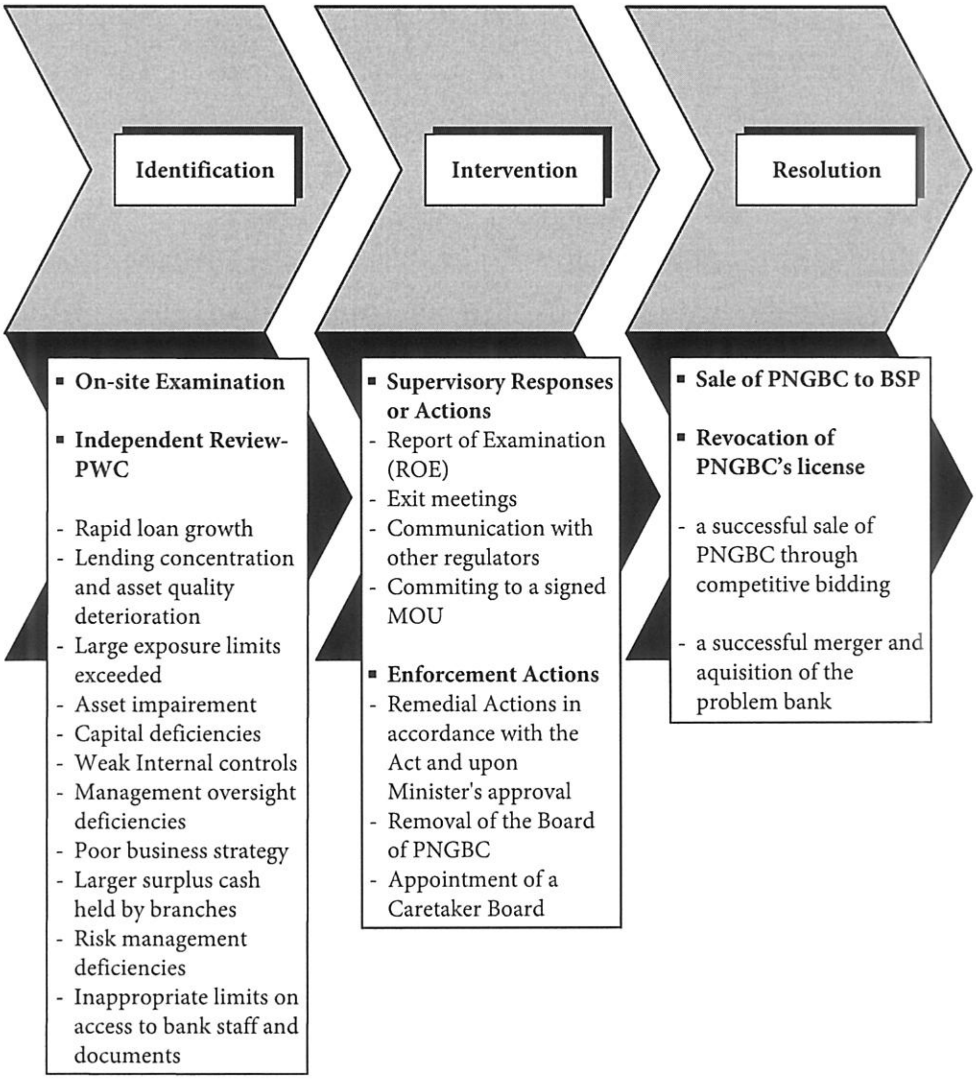
Appendix 1a

Problem Bank Identification, Intervention and Resolution in Papua New Guinea

(Based on PNG's experience with Papua New Guinea Banking Corporation)



Appendix 1b

PROBLEM BANK: PAPUA NEW GUINEA BANKING CORPORATION (PNGBC)

1. Problem Bank Identification: The Case of PNGBC

Due to resource constraints and lack of supervisory oversight by the Banking Supervision Department (BSD) at the time, the BPNG requested Price Waterhouse Coopers (PwC), an accounting & auditing firm to assist with an examination to review the loan portfolio and internal control systems of PNGBC in 1998 and again in 2000.

Similarly, the Finance Pacific Group (FPG) which is the holding company of PNGBC, requested PwC to undertake a diagnostic review on PNGBC and its wholly owned subsidiary, Nambawan Finance Limited in March 2000. The review was aimed at identifying areas for improvement, which might enhance the value of the divestment given the Government's stated intention to privatise PNGBC and its subsidiaries. Although the review was requested by the FPG, a copy of the review report was made available to BPNG. Both reviews uncovered many problems with varying degrees of severity that were critical to the viability of the bank and the financial system as a whole. This was because PNGBC was the largest bank with an extensive branching network in PNG and total market share of K1,355.14 million as at December 2001.

Below is a brief account of some of the problems uncovered during the review and actions taken by BPNG and the Government to resolve the problems and privatize the bank.

a. Rapid Loan Growth

Significant growth in assets was reported. PNGBC was increasing its lending at an unsustainable and alarming rate over the six months from January to June 1998 by about 30% against the market trend. This includes an exposure of K50 million to its subsidiary company, the PNGBC Holding No.1 Pty Ltd. When lending is higher than the general level of economic activity, this could be expected to increase the level of risk in the loan portfolio, particularly given the sharp increases in interest rates at the time.

b. Lending Concentration & Asset Quality Deterioration

(i) The quality of the assets deteriorated and was of great concern. The bank's strong orientation towards the financial needs of the average population (asset side) was not reflected on the credit side. It was more focused on sectors such as agriculture, fishing, forestry and logging which were riskier requiring high provisioning for bad debts. The industry concentrations were not closely monitored by PNGBC and contributed to the poor performance.

(ii) As at December 1997, exposures to 23 customers amounted to K396 million, representing 66.4 per cent of the total portfolio of K596 million. These large loans performed so poorly that they threatened the bank's liquidity and solvency.

(iii) As at December 1998, only 1.7 per cent of the bank's loan portfolio comprised personal loans, with a maximum credit size of K10,000. PNGBC's experience is even more limited regarding the credit business with small and medium enterprises. As at December 1997, PNGBC had about 400 outstanding loans in this market segment with an estimated loan default rate of more than 40 percent.

c. Large Exposures

As at 31 December 1999, there were 5 non-group exposures, which exceeded PNGBC's prudential limits (plus 2 borderline exposures). Intra-group exposures to Motor Vehicle Insurance Limited (MVIL) and Nambawan Finance Limited (NFL) were in excess of prudential large exposure limits for individual and aggregate connected parties.

PNGBC had inadequate processes in place to assess large exposures, including lack of rigorous measures to prevent future overexposures and to contain existing large exposures.

d. Asset Impairment

Even with the high rate of non-performing assets, the bank failed to apply its policy with respect to the treatment of impaired assets. Concerns were also raised about the recoverability of certain claims made against the Government of Papua New Guinea.

e. Capital Deficiencies

While PNGBC's capital as at December 1997 was 7.89%, it was grossly insolvent as adjustments to capital were not considered by the bank. As at 31 December 1998 the bank's capital marginally increased above 8%. Again, as the adjustments were not considered, the ratios given in the table below do not accurately reflect the extent of deterioration in PNGBC's capital.

	Jun-01	Dec-00	Jun-00	Dec-99	Jun-99	Dec-98	Jun-98	Dec-97	Jun-97
Minimum Requirement	10.0%	10.0%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
CAR	5.98%	5.04%	8.01%	15.93%	14.50%	8.70%	4.86%	7.89%	12.40%

After 1998, there were discussions and attempts within the BPNG to increase the capital requirements and CAR. The PwC review found that with increases in both kina amount (from K5 m to K15 m) and capital ratio (from 8% to 10%); PNGBC would still suffer a significant short fall. Note also that during 1999, the Government, being the shareholder of the bank, made a decision to amalgamate the PNGBC's holding companies with the problem bank to create a single entity. As a result, CAR of the bank had increased significantly in 1999.

As the regulator, BPNG had great concern about the amalgamation. There were relatively low levels of capital in PNGBC as well as the FPG companies, particularly MVIL which presented a potential contagion risk to PNGBC. MVIL had a number of subsidiary companies, most of which were non-performing or not operating. Thus, the review by PwC recommended to the board of PNGBC to consider isolating the bank and its subsidiaries from that risk by separating MVIL from the FPG. The recommendation was accepted by the board of PNGBC and implemented in 2000.

f. Internal Controls

There were substantial weaknesses in almost all aspects of the internal control systems of the bank, particularly in the lending, treasury and foreign exchange operations. The weaknesses included outdated or no manuals for some activities, an inadequate information system and inappropriate procedures regarding the origins of transactions, accounting and recording, monitoring and review and reporting of transactions.

g. Management Oversight Deficiencies

Within the bank's organizational structure, responsibilities and reporting lines were not clearly defined resulting in overlaps and inefficiencies. The deficiencies include:

- overlap in the roles of the Executive Chairman, Managing Director and General Manager – Banking;
- potential for a flatter structure with more direct reporting channels; and
- no appropriate representation at Executive Committee level for certain key operational divisional heads.

The Head Office and Support Function of PNGBC had a support role of other companies within the FPG. The review recommended that a decision be made separating the activities for PNGBC and those for FPG.

h. Business Strategy

The review identified that the strategy document was not wholly complete or integrated with various other divisional business plans. There was no comprehensive strategic plan prepared at the Board level to provide direction and guidance to all business units within PNGBC.

PNGBC had not adopted a specific strategic approach in developing particular markets, customers, products or services. Instead, it relied on its traditional banking businesses and placed a lot of emphasis on expansion and customer-outreach at the expense of profitability as the bank was expected to deliver banking services as part of its social obligation to the communities. This caused some branches, sub-branches and agencies to be unable to sustain operations and forced closures.

i. Surplus cash held by branches

High levels of currency notes were being held at branches. Cash holdings at branches should have been reduced to a more appropriate level to preclude exposures to crime and to re-deploy to earning assets.

j. Risk Management Deficiencies

i) *Risk Management Framework* - PNGBC failed to develop a risk management framework to be used in identifying, measuring and monitoring risks on a bank-wide basis. It also had fundamental weaknesses in its procedures and risk controls. The Board and management's lax attitude towards putting in place systems and processes to mitigate risks led to more serious problems. The bank's appetite and tolerance levels for risk were not clearly stated. A risk appetite and attitude should have been developed to drive the establishment of various risk limits for the Treasury and International Departments and other business units of the bank.

ii) *Policies & Procedure* - PNGBC failed to have adequate and appropriate policies in place. Furthermore, existing policies were not updated to reflect the changes taking place within the organization.

iii) *Human Resource/Personnel* – PNGBC's personnel cost ratios were one-and-half times more compared to the other banks. It had the highest number of staff per branch and the lowest level of assets per branch.

Political interference with the operations of the bank resulted in the promotion of inexperienced managers and loan officers. The loan book continued to deteriorate in the process. Also, with the political appointment of the CEOs, a lack of continuity in key positions within the bank created uncertainties.

iv) *Management Information System* - The Integrated Banking System (IBS) had weaknesses that impeded on proper controls of the lending function. Lack of improvement or enhancement in the system led to it being deficient in:

- loan grading by asset quality;
- flagging the expiry of security documentation;
- improvements in loan arrears reporting;
- identification of related group of borrowers;
- accurate assessment of concentration risk within the loan portfolio; and
- historical provisioning levels.

k. Communicating Concerns

Effective, accurate and frequent communication is extremely important in problem banks and it was no different with PNGBC. Hence, BPNG was careful in how to address the issues. This is because the troubled bank was a large bank and its closure could have significantly affected confidence in the banking industry and have destabilizing effects on the financial system and the overall economy. In the resolution process, there was ongoing communication between BPNG, PNGBC and the Minister for Treasury and Finance.

2. Problem Bank Intervention: The Case of PNGBC

In the process of rehabilitating the troubled bank, BPNG took certain corrective actions and ensured subsequent monitoring for adherence to those supervisory enforcement actions. Detailed below were some of the rehabilitation actions.

a) Informal Supervisory Responses or Actions

i) *Communication through the Report of Examination (ROE)* - From the reviews conducted by PwC and the Bank and as part of the examination process, a ROE discussing potential and significant problems affecting the bank were communicated to the Board with recommendations for corrective actions.

ii) *Meetings and Consultations* - Exit meetings were held after the examinations/ reviews to discuss the issues identified during the examinations. Many other meetings and consultations were convened during the whole process as problems were identified with the management and the Board.

iii) *Communication with other Regulators* – the only other financial supervisor with interest in the FPG was the Insurance Commissioner. Continuous dialogue between the Bank and the Commissioner took place due to the fact that MVIL, a subsidiary is involved with insurance.

iv) *Memorandum of Understanding (MOU)* – was also used where all stakeholders involved had to provide their undertaking in resolving the issues.

b) Formal Enforcement Actions

i) BPNG, with the approval of the Minister for Treasury and in accordance with Sec. 18(2)(a) and (b) of BFIA, had directed the bank to refrain from extending any further loan commitments to any clients while at the same time endeavor to recall any existing commitments where commercially and legally feasible, until such time as the capital adequacy ratio has been restored and all other prudential concerns have been rectified.

ii) BPNG, using powers under the BFIA, removed the Board of PNGBC and replaced it with independent directors who had demonstrated integrity.

3. Problem Bank Resolution: The Case of PNGBC

(a) Sale of Problem Bank

In line with the Government's policy to privatize the government owned institutions, including the troubled bank, PNGBC was prepared for sale. This was despite the significant improvement in the financial position of the troubled bank following BPNG's intervention Within the GoPNG's short time-frame for the privatization of PNGBC, considerable efforts were made to enhance the value of the bank to bring to the point of sale.

During the whole process, issues prevalent in a normal sale were discussed at great lengths and resolved before the necessary agreements were signed. This included issues on shareholding (controlling interest at 51% or more), bad debts, safety of depositor's funds of both banks, future dividend payments by the acquiring bank, capital requirements of the acquirer and other related issues. The bids to acquire the trouble bank were issued in late 2001. The successful bidder was a local privately-owned bank, Bank South Pacific Limited.

At the time of sale, prudential regulation and supervision under the new regime has improved considerably. Therefore, care was taken to ensure that the acquiring bank complied with all the prudential requirements and regulations imposed by the relevant authorities before the acquisition and amalgamation took place. Some issues remained unresolved but with the understanding that these matters would be resolved in the normal course of supervision, and acting within the privatization time-frame to sell the bank, BPNG approved the sale to BSP in April 2002. Additional conditions were imposed on the acquirer's license regarding the unresolved matters.

(b) Revocation of PNGBC's License

BPNG also consented to surrender the license of the troubled bank to take effect on the date of the acquisition. However, this did not eventuate due to certain unresolved issues. The revocation of the license of PNGBC was eventually done in July 2002.