

**Republic of Palau: Assessment of the Supervision and Regulation of the Financial Sector—Volume I—Review of Financial Sector Regulation and Supervision**

This review of financial sector regulation and supervision in the **Republic of Palau** in the context of the offshore financial center assessment program contains technical advice and recommendations given by the staff team of the International Monetary Fund in response to the authorities of the **Republic of Palau's** request for technical assistance. It is based on the information available at the time it was completed in **May 2002**. The staff's detailed assessment of the observance of standards and codes can be found in Volume II. The views expressed in these documents are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Palau** or the Executive Board of the IMF.

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**ASSESSMENT OF THE SUPERVISION AND REGULATION OF THE  
FINANCIAL SECTOR**



**Volume I: Review of Financial Sector Regulation  
and Supervision**

**Palau**

**MAY 2002**

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## Preface

At the request of the Palauan authorities, an MAE-led mission visited Koror during April 3–16, 2002, to assess observance of financial sector supervisory standards in the context of a stand-alone (Module 2) assessment.<sup>1</sup> The assessment focused on compliance with international supervisory standards and anti-money laundering arrangements in the banking sector.<sup>2</sup>

The mission consisted of Mr. Luca Errico (Mission Chief, Monetary and Exchange Affairs Department (MAE) of the International Monetary Fund (IMF), Ms. Cecilia Marian (Legal Department (LEG, IMF), and Mr. Tuomo Malin (Financial Supervision Authority of Finland). The mission was assisted in the field by Mr. John Vaught, the MAE Banking Supervision Advisor assigned to the Financial Institutions Commission of Palau on a peripatetic basis.

The mission met with the President of the Republic of Palau, the Minister of Finance, the Minister of Justice, the Attorney General, the Chair and members of the Financial Institutions Commission, the Acting Executive Commissioner of the Financial Institutions Commission, the Coordinator of the Financial Intelligence Unit, and their staffs. The mission also held meetings with senior members of the *Olbiil Era Kelulau* (Congress, hereinafter OEK) and representatives from the Chamber of Commerce, the National Development Bank of Palau, as well as foreign and domestic private commercial banks.

The mission would like to express its sincere thanks to the Palauan authorities and to all officials and market participants involved in the meetings for the outstanding cooperation and gracious hospitality received during its stay in Koror.

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<sup>1</sup> The Module 2 assessment is described in “*Offshore Financial Centers—The Role of the IMF*,” June 23, 2000, [www.imf.org](http://www.imf.org).

<sup>2</sup> For the review of anti-money laundering and combating the financing of terrorism practices, the mission was guided by the expanded draft methodology document “*Fund and Bank Methodology for Assessing Legal, Institutional, and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism*” that was issued to the Fund’s Executive Board on February 7, 2002.

## Executive Summary

This report contains the main findings and recommendations of the MAE-led mission that visited Koror during April 3-16, 2002, to conduct a Module 2 assessment in the context of the IMF's Offshore Financial Centers (OFC) initiative. This is the first formal MAE visit to Palau, although the authorities maintain an ongoing dialogue with the Pacific Financial Technical Assistance Center (PFTAC) and have been assigned by MAE a Banking Supervision Advisor on a peripatetic basis in FY2002. **Appendix I** of Volume I of this report provides background information and recent developments in the macroeconomic, financial, and institutional environment in Palau. The mission assessed compliance with supervisory and regulatory principles relative to the *Basel Core Principles for Effective Banking Supervision*. In addition, it evaluated Palau's anti-money laundering (AML) arrangements in the banking sector using the IMF and World Bank expanded anti-money laundering methodology.

\* \* \*

The enactment of the Financial Institutions Act (FIA) and four anti-money laundering laws in June 2001 was a major development toward establishing an effective regulatory and supervisory framework for financial institutions, as well as combating money laundering and associated criminal activities. Pursuant to the new financial legislation, the Palauan authorities moved swiftly and decisively to weed out questionable financial institutions from the country. As a result, of the 30 plus financial institutions known to be active in Palau only 12 applied for a banking license under the "grandfathering" provisions of the FIA.<sup>3</sup> Most notably, around September 2001, the authorities revoked the licenses of 10 shell corporations which had been registered as banks. This, together with the repeal of the Offshore Banking Act in 1982 and the non-existence of company service providers and International Business Companies (IBCs), has resulted in offshore business being virtually absent in Palau at the time of writing.

Palau's Government demonstrated a clear political commitment to AML: in addition to being a signatory to the Honiara Declaration, it has more recently volunteered to participate in an initiative led by the Forum Secretariat and the Asia/Pacific Group on Money Laundering to assist the countries in the Pacific region to put in place effective measures for anti-money laundering, combating terrorism financing and financial sector fraud that is being funded by LEG. Palau's Government also indicated its intention to join the Asia/Pacific Group on Money Laundering. The authorities are to be commended for their commitment and resolve to establishing a safe and sound financial environment in Palau.

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<sup>3</sup> At the time of writing, these twelve institutions are operating under a business license granted by the Tax Office. The authorities have already taken steps, including legal action, that are expected to result in the closure of up to two of these twelve institutions.

Nonetheless, the changes to the FIA made by the OEK before enacting the law, the delays in establishing the Financial Institutions Commission (FIC) to implement it, together with the newness of the concept of prudential supervision and that no meaningful implementation capabilities have been developed as yet, imply that substantial additional efforts are needed to bring Palau at par with international standards and best practices, notably in the area of banking supervision and prudential regulation. Difficult issues arising from the current “grandfathering” arrangements need to be addressed quickly to avoid undermining the recent legislative initiatives. There is also an urgent need of making progress in the implementation of the recently enacted AML/CFT measures.

Recognizing the situation, the authorities requested that the mission undertake a thorough diagnosis to assist them in taking stock of the existing situation and focusing their attention on priority actions needed to achieve the goal of compliance with international standards and best practices. In this connection, they also requested that the mission provide specific recommendations and an action plan, as well as a technical assistance work program to help achieve that goal.

### **Banking Supervision and Prudential Regulation**

The mission assessed Palau’s observance of the *Basel Core Principles for Effective Banking Supervision* (BCPs). As anticipated, Palau’s overall degree of compliance with the BCPs was found to be modest given the newness of the concept of prudential supervision and that no meaningful implementation capabilities have been developed as yet.

Although some of the Core Principles currently assessed as non-compliant or materially non-compliant may, in due course, be brought into compliance through the drafting of prudential regulations by the newly established FIC and the development of adequate implementation capabilities, including through an intensive technical assistance program (below), the assessment underscored a number of major outstanding issues—mostly related to weaknesses in the FIA—which, if left unaddressed, may jeopardize or even impede effective banking supervision in Palau. These include an excessive influence of representatives from the banking industry in the Governing Board (GB) of the FIC; a lack of legal protection for the FIC’s GB and its staff; major constraints on the lawful exercise of the regulatory and supervisory powers vested in the FIC; limitations on the operational autonomy of the FIC in terms of not being able to fully recover its financing and budgeting needs from the supervised entities that affect its ability to hire qualified staff to implement the provisions of the FIA; the existence of “grandfathering” provisions detracting from the FIC’s ability to ensure that the twelve institutions which applied for a banking license are financially sound (solvent and liquid) and properly managed prior to licensing; overly-extended and unclear transition periods for coming into compliance with the prudential requirements under the FIA; insufficient attention to the need for timely preparation, certification, and disclosure of balance sheets and income and expense statements for licensed banks; and an undue use of the FIC for actively pursuing the reinvestment policy/objectives of the government. Additionally, the assessment underscored a number of technical shortcomings in the prudential requirements of the FIA, as detailed in **Volume II** of this report.

To address the above-noted issues, the mission: (i) urges that an agreement for the designation and subsequent Senate confirmation of the missing fifth voting member of the FIC's GB be accomplished as soon as possible and that this individual be from outside the Palauan banking industry; (ii) recommends that Section 16 of the FIA be amended to remove the ineligibility of government employees to serve on the GB; (iii) urges that the FIA be amended to include a provision granting legal protection to the FIC's GB and staff when acting in good faith within the scope of their authority. In this connection, the mission welcomes the President's submission of an ad-hoc Bill to Congress and fully supports him in his endeavors to obtain approval of the Bill; (iv) strongly recommends that the FIA be amended to remove Sections 79(a), 62(b)(3), and 33(b) that unduly limit the ability of the FIC to lawfully exercise its regulatory and supervisory powers; (v) recommends that Sections 34 and 79 of the FIA be amended to allow the FIC to determine and set by regulation the level of fees applied on supervised entities based on its funding and budget requirements; (vi) urges that the hiring of the FIC's permanent staff, including the Executive Commissioner, be done as soon as possible and in any case by and not later than the end of the current fiscal year (September 30, 2002); (vii) recommends that, at a minimum, the FIC be allowed to assess the solvency position and "fit-and-proper" criteria for the twelve applicants under the "grandfathering" provisions of the FIA prior to granting a banking license; (viii) recommends that Section 77(b) of the FIA be amended to the effect that the transition period for coming into compliance with *all* prudential requirements under the FIA be reduced to *12 months from the date the FIC was established*, i.e., by February 21, 2003; (ix) recommends that, by the end of the transition period as recommended above, all banks so licensed should, at a minimum, be required to prepare an annual balance sheet and income and expense statements on a consolidated basis following Generally Accepted Accounting Principles (GAAP); have them audited by a reputable external auditor; and make them available to the public through publication or upon request, as well as the FIC; (x) recommends that Section 55 of the FIA be amended to remove the requirement that the FIC should propose regulatory and legislative measures to implement the government's reinvestment policy; and (xi) recommends that the technical shortcomings in the prudential requirements of the FIA be addressed as specified in Volume II of this report.

### **Legal, Institutional, and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)**

The mission assessed Palau's legal, institutional, and supervisory aspects of anti-money laundering and combating the financing of terrorism (AML/CFT), using the "*Fund and Bank Methodology for Assessing Legal, Institutional, and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism*" that was issued to the Fund's Executive Board on February 7, 2002. The mission's overall assessment is that Palau has a largely satisfactory legal and institutional framework for preventing and detecting money laundering in the banking sector, while implementation capabilities need strengthening.

The assessment underscored a gap in the supervisory regime governing AML as the supervisory authority charged with the responsibility for the implementation of AML



requirements and audit compliance with AML legislation is not clearly identified. The initial thinking in Palau's Government was that the FIC should have that responsibility. However, should it be the case, the mission notes that there would be a residual group of reporting entities, such as exchange offices and money transmitters, that are not regulated and supervised by the FIC and, therefore, the question of who would be the relevant supervisory authority for those intermediaries would still remain. In order to make the distinction in responsibilities more clear, and to provide a single entity, the Financial Intelligence Unit (FIU), with clear AML inspection, compliance, and enforcement powers, the mission strongly recommends that the *FIC* should be responsible for establishing *AML policies and procedures for banks*, while the *FIU* should be given responsibility for the *day-to-day implementation (including on-site inspection) and enforcement of AML requirements for all reporting entities, including banks*. Additionally, the mission recommends technical amendments to the legal framework (as stated below) to ensure an effective implementation of the AML legislation.

The mission found that implementation capabilities need strengthening. This is due to a number of factors: (i) while providing for the establishment of an FIU, the AML legislation does not provide it with clear enforcement powers; (ii) the FIU is currently understaffed and lacks sufficient expertise to carry out the tasks assigned to it by the legislation, especially in the analysis of suspicious transactions; and (iii) banks need to be provided with clear guidelines and recommendations from the FIU on how to deal with the practical aspects of day-to-day implementation of the AML legislation. The mission recommends a number of measures (below) to address these issues.

### **Technical Assistance Needs**

Based on its findings, the mission is of the view that banking supervision and regulation should receive first priority in Palau's technical assistance (TA) needs. In this connection, the mission reviewed the work program for the MAE Banking Supervision Advisor assigned on a peripatetic basis to the FIC that was originally prepared with assistance from PFTAC. It revised this program to more clearly distinguish between TA actions needed to strengthen the regulatory and supervisory framework, e.g., drafting necessary regulations and reporting forms, and TA actions needed to develop and foster implementation capabilities. The mission is of the view that, in the current circumstances, the latter is to be given a particular emphasis. It thus recommends an intensive on-the-job, hands-on training program for the FIC's GB and staff, the latter to begin as soon as the FIC's budget is approved and the hiring of permanent staff occurs. The mission's recommended TA work program on banking supervision and prudential regulation is included in **Appendix II** of Volume I of this report.

In the area of AML/CFT the authorities indicated a need for TA to review and assist in the drafting of amendments to the AML/CFT legislation as recommended herein; to assist in the drafting of necessary AML/CFT regulations; to assist in the establishment of a well-functioning FIU; and to provide training to FIU staff and banks in the practical aspects of AML/CFT implementation.

The mission noted that MAE and LEG are already providing TA covering some of these areas, including through the fielding of this mission, and the assignment of expert resources on a peripatetic basis. That said, the mission also indicated that the IMF (MAE & LEG) would consider additional TA requests favorably, depending on the authorities' reform commitment and implementation record, and subject to its TA budgetary constraints.

**Table 1. Palau: Summary of Main Recommendations and Action Plan**

<b>Subject</b>	<b>Timetable</b>
<b>Banking Supervision and Prudential Regulation</b>	
Amend the FIA to include a provision granting legal protection to the FIC's GB and staff.	Immediately.
Amend Section 16 of the FIA to remove the ineligibility for government employees to serve on the FIC's GB.	Immediately.
Allow the FIC to assess the solvency position and "fit-and-proper" criteria of the 12 applicant institutions under the "grandfathering" provisions of the FIA before granting a banking license.	Immediately
Reach agreement for the designation and Senate confirmation of the fifth voting member of the FIC's GB. This individual should be from outside the Palauan banking industry.	As soon as possible.
Remove Sections 79(a), 62(b)(3), and 33(b) of the FIA that unduly constrain the supervisory and regulatory powers of the FIC.	As soon as possible.
Amend Sections 34 and 79 of the FIA to allow the FIC to determine and set by regulation the level of fees applied on supervised entities.	As soon as possible.
Amend Section 77(b) of the FIA to the effect that the transition periods for coming into compliance with <i>all</i> requirements under the FIA be reduced to 12 months from the date the FIC was established, i.e., by February 21, 2003.	As soon as possible.
Amend Section 55 of the FIA to remove the requirement that the FIC should propose regulatory	As soon as possible.

<p>and legislative measures to implement the government's community reinvestment policy.</p> <p>Implement the mission's recommendations to address the technical shortcomings in the prudential requirement under the FIA, as specified in the <i>Recommended Action Plan to Improve Observance of the Basel Core Principles</i> in Volume II.</p> <p>Hire permanent staff for the FIC, including the Executive Commissioner, to implement the provisions of the FIA.</p> <p>Require that, at a minimum, all banks licensed to operate in Palau should prepare an annual balance sheet and income and expense statements on a consolidated basis following GAAP; have them audited by a reputable external auditor; and make them available to the public through publication or upon request, as well as the FIC.</p> <p style="text-align: center;"><b>Anti-Money Laundering and Combating the Financing of Terrorism</b></p> <p>Begin implementation of the existing AML provisions.</p> <p>Assign the FIC with responsibility for establishing policies and procedures for AML for banks and assign the FIU with responsibility for the day-to-day implementation (including on-site inspection) and enforcement of AML requirements for all supervised entities, including banks.</p> <p>Provide the FIU with sufficient staff resources to enable it to fulfill its duties under the AML legislation.</p> <p>Implement the mission's technical recommendations to ensure an effective implementation of the AML legislation, as specified in the <i>Recommendations to Improve the Implementation of the AML/CFT Measures</i> in Volume II</p>	<p>As soon as possible.</p> <p>By and not later than September 30, 2002.</p> <p>By the end of the transition period as recommended above.</p> <p>Immediately.</p> <p>As soon as possible.</p> <p>As soon as possible.</p> <p>As soon as possible.</p>
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## I. BANKING SUPERVISION AND PRUDENTIAL REGULATION

1. The mission assessed Palau's observance of the *Basel Core Principles for Effective Banking Supervision* (BCPs). As anticipated, Palau's overall degree of compliance with the BCPs was found to be modest given the newness of the concept of prudential supervision and that no meaningful implementation capabilities have been developed as yet. The mission assessed Palau to be compliant with 1 Core Principle (CP); largely compliant with 6 CPs; materially non-compliant with 7 CPs; and non-compliant with 11 CPs. **The detailed assessment of Palau's observance of the BCPs is included in Volume II of this report.**

2. Although some of the CPs currently assessed as non-compliant or materially non-compliant may, in due course, be brought into compliance through the issuance of prudential regulations by the newly established Financial Institutions Commission (FIC) and the development of adequate implementation capabilities, including through an intensive technical assistance program (below), the assessment underscored a number of major outstanding issues—mostly related to weaknesses in the Financial Institutions Act (FIA)—which, if left unaddressed, may jeopardize or even impede effective banking regulation and supervision in Palau. These issues can be summarized as follows.

### A. Composition of the FIC's Governing Board

3. The FIC was established on February 21, 2002 (some eight months after the FIA was enacted in June 2001), when four of the five voting members of its Governing Board (GB)—chosen by the President from a list of ten names submitted by the Chamber of Commerce—were formally confirmed by the Senate.<sup>4</sup> The Chair and Vice-Chair of the GB are representatives from the business community, while the other two voting members are bankers (representing one domestic and one foreign commercial bank). The President of the state-owned National Development Bank of Palau is, *ex-officio*, the sixth non-voting member of the GB.

4. While appreciating Palau's circumstances that significantly constrain the pool of eligible candidates available to serve in the GB of the FIC, the mission notes that the present composition of the GB provides the banking industry with excessive influence on the operations of the FIC; may lead to potentially serious conflicts of interest; and may result in operational paralysis. Indeed, these issues were candidly acknowledged or even raised by some bankers during meetings with the mission. The mission, therefore, urges that an agreement for the designation and subsequent Senate confirmation of the missing fifth voting member of the GB be accomplished as soon as possible and that this individual be from

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<sup>4</sup> According to an interpretation of Palauan legislation provided by the Attorney General's office, the missing voting member of the FIC does not affect its legal constitution and its ability to operate, provided a quorum of its members is present.

outside the Palauan banking industry.<sup>5</sup> In order to enlarge the pool of potential candidates, the mission further recommends that Section 16 of the FIA be amended to remove the ineligibility of government employees to serve on the GB, while preserving the Chamber of Commerce's present right to choose the individuals for the list of nominees to be submitted to the President.

### **B. Legal protection for the FIC's Governing Board and staff**

5. Although the FIC is now legally established and therefore has the ability to use the powers vested to it by the FIA, it has thus far refrained from taking any adjudicatory action—including deciding on the merits of the 12 applications for a banking license under the “grandfathering” provisions of the FIA—as a provision granting legal protection to the FIC's GB and staff when acting in good faith within the scope of their authority has not been included in the FIA. In addition to being contrary to international best practices, this situation is causing concern and uncertainty in the banking industry as their current licenses issued by the Tax Office expired on April 30<sup>th</sup> and are expected to be renewed for a limited period only. The mission, therefore, urges that the FIA be amended to include a provision granting legal protection to the FIC's GB and staff. In this connection, the mission welcomes the President's submission of an ad-hoc Bill to Congress and fully supports him in his endeavors to obtain approval of the Bill.

### **C. Regulatory and supervisory powers of the FIC**

6. Section 78(a) of the FIA provides the FIC with full regulatory and supervisory powers to conduct effective banking regulation and supervision. However, other provisions of the FIA militate against that. Section 79(a) states that *all regulations* issued by the FIC shall take effect upon approval by the OEK by *joint resolution* (i.e., by both the Chamber of Representatives and the Senate). Moreover, Section 62(b)(3) specifically requires the FIC to seek the approval of the Supreme Court for the issuance of Cease and Desist Orders, thus making the Supreme Court the arbiter of what situations may qualify for such an order. Finally, Section 33(b) limits the conditions that the FIC may impose on a financial institution's license.

7. The mission notes that the combined effect of Sections 79(a), 62(b)(3), and 33(b) is to make the lawful exercise of regulatory and supervisory powers by the FIC an almost impossible exercise in practice and significantly impinge on the autonomy and authority of the FIC. This is cause for grave concern. The mission believes that the FIC should have the power to issue and enforce prudential regulations without external interference, provided that it operates within the scope of the FIA. These provisions pose formidable limitations on the ability of the FIC to exercise timely regulatory oversight in preventing and/or correcting

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<sup>5</sup> Two lawyers had been previously selected by the President to become voting members of the GB. One of them declined and the other one was not confirmed by the Senate.

weaknesses in supervised entities before they become serious threats to the stability of an individual institution or the system as a whole. The mission, therefore, strongly recommends that the FIA be amended to remove these above-mentioned provisions that unduly limit the ability of the FIC to conduct effective banking regulation and supervision.

#### **D. Financing, budget, and staffing of the FIC**

8. The FIA significantly constraints the ability of the FIC to raise sufficient resources to fund its operations. Section 34 limits the amount of fees that can be charged for the investigation of new applications to only \$500. This limitation may prevent the FIC from recovering expenses associated with the investigation of new applications, thereby limiting the thoroughness of background checks on proposed management and principal shareholders as well as the reviews/analysis of projections/business plans. Additionally, Section 79 of the FIA limits the amount of fees that can be charged to financial institutions to cover FIC's routine operations. Inasmuch as the expenses of the FIC are to be funded by fees assessed against supervised institutions (as stated in Section 79(b) of the FIA), the mission believes that the FIC should have the authority to determine and set by regulation the level of fees (both for new applications and for routine expenses) based on its funding/budget requirements. The mission therefore recommends that Sections 34 and 79 of the FIA be amended to that effect. In the interim, government funds may be needed to cover the difference between the FIC's budget requirements and the funds recovered from the supervised entities. The Acting Executive Commissioner has prepared a draft FIC budget for the year 2002/03, which is expected to be finalized by September 30, 2002.<sup>6</sup> In this connection, the mission urges that the hiring of the FIC's permanent staff, including the Executive Commissioner, be done as soon as possible and in any case by and not later than the end of the current fiscal year, i.e., September 30, 2002.

9. Additionally, the mission notes that there is a need to clarify the intent of Section 12(a)(2) of the FIA requiring the FIC to "propose and submit" its budget to the OEK: if the intent is an implicit requirement that the OEK approve the FIC's budget, the autonomy of the FIC may be affected inasmuch as the potential for political interference does exist in a small island state such as Palau. Indeed, in the original draft FIA, it was proposed that the budget be submitted to the OEK for informational purposes only. The mission believes that this should be the case.

#### **E. Licensed banks under "grandfathering" provisions**

10. The FIA, as enacted, provided for existing financial institutions to be licensed by the FIC without applying "fit and proper" criteria. The mission notes that the grandfathering provisions of the FIA detracted from the FIC's ability to ensure that the twelve institutions which applied for a banking license are financially sound (solvent and liquid) and properly managed prior to licensing. The mission therefore recommends that, at a minimum, the FIC

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<sup>6</sup> The fiscal year in Palau is October 1<sup>st</sup> -September 30<sup>th</sup> .

be allowed to require these twelve institutions to: (1) submit a plan acceptable to the FIC for increasing capital to the minimum levels set forth in the FIA (both absolute and risk-based capital). In this connection, the mission recommends that any capital deficient bank should be required to inject additional cash funds to correct the deficit capital position and to increase capital to a level sufficient to support operating expenses until profitability can be reasonably assured (as demonstrated in an acceptable business plan); and (2) provide the FIC with necessary information to enable it to assess the “fit-and-proper” criteria for controlling shareholders and management.

#### **F. Transition period**

11. Section 77(b) of the FIA provides the banks licensed under “grandfathering” provisions with transition periods to come into compliance with various prudential requirements of the FIA ranging from 24 months (for organization and administration) to 48 months (for accounting, auditing, and reporting) beginning from the date “*all* of the positions of the Governing Board of the FIC are filled” (Section 77(b), emphasis added).

12. The mission notes that, although the FIA has been in force for almost one year, the clock for coming into compliance with the requirements of the FIA is not yet ticking as the fifth voting position in the GB is still vacant. More fundamentally, while appreciating the concern expressed by local banks about the costs of coming into compliance, the mission believes that the current transition periods are overly extended given the straightforwardness of the prudential requirements under the FIA. It therefore recommends that Section 77(b) of the FIA be amended to the effect that the transition periods for coming into compliance with *all* prudential requirements under the FIA be reduced to 12 months from the date the FIC was established, i.e., by February 21, 2003. In this connection, the FIC may be given the power to extend the transition period for up to 12 months based on its prudent judgment of individual circumstances.

#### **G. Preparation, certification, and disclosure of balance sheets and financial statements**

13. To enhance market discipline, it is recommended that by the end of the transition period as specified above, all banks licensed to operate in Palau should, at a minimum, be required in law to prepare an annual balance sheet and income and expense statements on a consolidated basis following Generally Accepted Accounting Principles (GAAP); have them audited by a reputable external auditor; and make them available to the public through publication or upon request, as well as submit them to the FIC.

#### **H. Community reinvestment provision**

14. The mission notes that the community reinvestment provision in Section 55 of the FIA requires the FIC to propose within 12 months regulatory and legislative measures to improve implementation of Palau’s community reinvestment policy. The mission is of the view that the FIC is improperly being given the responsibility for actively pursuing the reinvestment policy/objectives of the government. It therefore recommends that the portion of Section 55 reading “Not later than 12 months after the effective date of this Act, the

Commission shall promulgate regulations to implement the provision of this section. The Commission shall regularly monitor the implementation of this section and report annually to the President and OEK on community reinvestment by all licensees under this Act. As part of its report the Commission shall propose regulatory and legislative measures to improve implementation of the Republic's reinvestment policy" be deleted.

### I. Other regulatory issues

- The mission notes that in Section 53 of the FIA the minimum capital to risk-weighted assets (CAR) requirement was reduced from 10 percent to 5 percent, which is substantially below the minimum requirement of 8 percent as set by the Basle Committee on Bank Supervision. Additionally, the minimum absolute level of capital, as provided in Section 31, was reduced from \$1 million (which was already significantly below the \$5 million international norm) to \$500,000. It is recommended that Section 53 be amended to increase the minimum level of the CAR to the minimum international requirement of 8 percent. It is also recommended that Section 31 be amended to allow the FIC to set the minimum absolute level of capital by regulation, taking into consideration current economic conditions.
- The mission notes that Section 66(c) of the FIA curtails the FIC's powers to address safety and soundness concerns as it establishes that the primary purpose of the FIC's examinations is the disclosure of irregularities and malfeasance in a bank. In order to enable the FIC to take timely corrective action, the mission recommends that the FIA should include a risk management provision, providing the FIC with the ability to make a qualitative judgment on a bank's general risk situation.
- The FIA should include clear rules on what kind of banks' investments need supervisory approval and which are subject to notification only. In this connection, a major consideration would be whether envisaged corporate affiliations, both domestic and overseas, might jeopardize the effective supervision of a bank.

### II. LEGAL, INSTITUTIONAL, AND SUPERVISORY ASPECTS OF ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

15. The mission assessed Palau's legal, institutional, and supervisory aspects of anti-money laundering and combating the financing of terrorism (AML/CFT), using the "*Fund and Bank Methodology for Assessing Legal, Institutional, and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism*" dated February 7, 2002. Of the 12 broad criteria assessed, the mission found Palau to be compliant with 2 criteria; largely compliant with 5 criteria; materially non-compliant with 3 criteria; and non-compliant with 2 criteria. **The detailed assessment of Palau's AML/CFT is included in Volume II of this report.**

16. Palau's Government has demonstrated a clear political commitment to ensure that strong AML/CFT measures are in place for the entire financial system. In addition to enacting four AML laws in June 2001 and being a signatory to the Honiara Declaration, the



Palau Government has more recently volunteered to participate in an initiative led by the Forum Secretariat and the Asia/ Pacific Group on Money Laundering to assist the countries in the Pacific region to put in place effective measures for anti-money laundering, combating terrorism financing and financial sector fraud that is being funded by LEG. In this connection, the Palau Government has agreed that LEG undertake an assessment of its FIU's operations and AML framework. Additionally, Palau's Government intends to join the Asia/Pacific Group on Money Laundering. On November 19, 2001, a Coordinator for the FIU was appointed to initiate implementation of Palau's AML legislation.

17. Further, in response to the calls by various international bodies to have in place measures to combat the financing of terrorism (CFT), Palau is in the process of drafting anti-terrorism legislation and has set up a Task Force on Anti-Terrorism and Homeland Security. Expectations are that this legislation will be enacted shortly.

18. The mission's overall assessment is that Palau has a largely satisfactory legal and institutional framework for preventing and detecting money laundering in the banking sector. Some fine-tuning of the legal framework is nonetheless necessary to ensure an effective implementation of the AML legislation. That said, the mission also finds that implementation capabilities need strengthening. This is due to a number of factors: (i) while providing for the establishment of a FIU, the AML legislation does not provide it with clear enforcement powers; (ii) the FIU is currently understaffed and lacks sufficient expertise to carry out the tasks assigned to it by the legislation, especially in the analysis of suspicious transactions; and (iii) banks need to be provided with clear guidelines and recommendations from the FIU on how to deal with the practical aspects of day-to-day implementation of the AML legislation. It is also crucial that all parties concerned recognize the importance of implementing the existing AML provisions. In addition, the authorities should ensure that the FIU undertakes on-site AML inspections of all reporting entities on a regular basis.

19. The mission reviewed the provisions of the Financial Institutions Act 2001 (FIA) and is of the view that the FIA is adequate with respect to the legal and institutional framework for the supervision and integrity standards for banks.

20. That said, the assessment underscored a gap in the supervisory regime governing AML as the authority charged with implementation of AML requirements is not clearly identified. The initial thinking in Palau's Government was that the FIC should have that responsibility. However, should it be the case, the mission notes that there would be a residual group of reporting entities, such as exchange offices and money transmitters, that are not regulated and supervised by the FIC and, therefore, the question of who would be the relevant supervisory authority for those intermediaries would still remain. Given the current constraints in terms of resources and technical expertise as well as the already heavy work agenda of the FIC, and in order to make the distinction in responsibilities more clear and provide a single entity, the FIU, with clear AML inspection, compliance, and enforcement powers, the mission strongly recommends that the *FIC* should be responsible for establishing *policies and procedures for AML for banks*, while the *FIU* should be given responsibility for the *day-to-day implementation (including on-site inspection) and enforcement of AML*

*requirements for all reporting entities, including banks.* Additionally, the mission recommends a number of technical amendments to the legal framework (as stated below) to ensure an effective implementation of the AML legislation.

21. These recommendations can be summarized as follows:

- Begin implementation of the existing AML provisions immediately;
- Amend the AML Law to include the following provisions: (i) specific record keeping requirements; (ii) lower the threshold when identifying casual clients; (iii) removal of the threshold of US\$10,000 for the record keeping requirement for customer identification; (iv) prohibition of anonymous accounts; (v) clarifying the suspicious transaction reporting requirements; (vi) extending the scope of the provisions overriding secrecy and the tipping off provisions; (vii) redefining the definition of money laundering so that the *mens rea* element is clearly set out; (viii) setting out the predicate offenses to which the money laundering offence relates, to take into account the views of the authorities that all crimes would be included as predicate offenses, and to include in the scope of predicate offenses similar offenses committed extraterritorially; (ix) extend the power to confiscate the proceeds of money laundering offenses and predicate offenses, instrumentalities and subject matter of money laundering offenses and, in the event that the proceeds of crime or instrumentalities or subject matter of the offense are not available for confiscation, the court should have the power to order confiscation of property of an equivalent value or a penalty sum equivalent to the value of property; (x) include adequate procedures for the protection of innocent and bona fide third party interests; and (xi) require customer identification for wire transfers;
- Amend the AML law to vest the FIU with the following powers: (i) to disseminate information that it receives, either on request or on its own initiative, to the relevant law enforcement agencies, foreign and local, where it suspects a money laundering offense, with adequate safeguards including confidentiality as to the use of the information so disseminated; (ii) to conduct on-site inspections and audit compliance of reporting entities with the AML law, and to have sufficient authority to enforce the AML law; (iii) to facilitate advisory activities, research and training and education of the public; (iv) to protect the FIU and its employees and the information that the FIU receives from suit and compulsory legal process; and (v) to have access to sources of public information;
- Remove the prohibition on FIU staff against concurrently holding any other public employment positions and/or an elective office in Palau;
- Provide the FIU with adequate staffing and expertise;
- Provide the FIU with powers to issue regulations for the effective implementation of the AML Law without the need for parliamentary approval;

- Establish a training program for the FIU, financial intermediaries, and the Attorney General's office in the relevant areas pertaining to money laundering. Technical assistance from MAE and LEG is being envisaged already for this purpose. It may be augmented if warranted;
- The FIC to issue regulations for "fit-and-proper" criteria for controlling shareholders and management of financial institutions under its purview. Specifically with respect to the banking sector, consideration should be given to requiring the application of the "fit-and-proper" tests to controlling shareholders and management of the 12 institutions which have applied for a banking license under the "grandfathering" provisions of the FIA;
- Enact the anti-terrorism legislation as soon as possible and issue regulations for the registration of over-the-counter exchange dealers.

### III. TECHNICAL ASSISTANCE NEEDS

22. Based on its findings, the mission is of the view that banking supervision and regulation should receive first priority in Palau's technical assistance (TA) needs. In this connection, the mission reviewed the work program for the MAE Banking Supervision Advisor assigned on a peripatetic basis to the FIC that was originally prepared with assistance from PFTAC. It revised this program to more clearly distinguish between TA actions needed to strengthen the regulatory and supervisory framework, e.g., drafting necessary regulations and reporting forms, and TA actions needed to develop and foster implementation capabilities. The mission is of the view that, in the current circumstances, the latter is to be given a particular emphasis. It thus recommends an intensive on-the-job, hands-on training program for the FIC's Governing Board and staff, the latter to begin as soon as the FIC's budget is approved and the hiring of permanent staff occurs. As previously noted, the mission urges that the hiring of the FIC's permanent staff, including the Executive Commissioner, be done as soon as possible and in any case by and not later than September 30, 2002.

23. The mission's recommended TA work program on banking supervision and prudential regulation is included in **Appendix II** of Volume I of this report.

24. In the area of AML/CFT the authorities indicated a need for TA to review and to assist in the drafting of amendments to the AML/CFT legislation as needed; to assist in the drafting of necessary AML/CFT regulations; to assist in the establishment of a well-functioning FIU; and to provide training to FIU staff and banks in the practical aspects of AML/CFT implementation. The mission noted that MAE and LEG are already providing TA covering some of these areas, including through the fielding of this mission, and the assignment of expert resources on a peripatetic basis. That said, the mission also indicated that the IMF (MAE & LEG) would consider additional TA requests favorably, depending on the authorities' reform commitment and implementation record, and subject to its TA budgetary constraints.

## APPENDIX I

### PALAU: BACKGROUND AND RECENT DEVELOPMENTS

#### A. Recent Developments in the Macroeconomic Environment

25. The Republic of Palau is an archipelago of more than 300 islands, with a population of some 19,200 individuals, constituting the westernmost group of the Caroline Islands in Micronesia. Although per capita GDP is high (\$6,180) compared with other Pacific Island countries, primarily because of large U.S. grants, the economy faces several challenges common to other small island economies, including a narrow productive base, a shortage of skilled labor, a small domestic market, inadequate infrastructure, and vulnerability to external shocks and natural disasters. Tourism and fishing are the main private sector activities. A large share of the active workforce (36 percent) is engaged in the public sector, accounting for almost 50 percent of all wages paid in 1999. Palau uses the U.S. dollar as legal tender.

26. Latest available data point to a weakening of economic activity and a worsening of fiscal performance in FY2001.<sup>7</sup> Real GDP growth has been estimated at around 1 percent in the past two years, with a slump in tourism only partly offset by the continuation of several large infrastructure projects. The overall fiscal deficit has widened to 15 percent of GDP, financed primarily, as in earlier years, by a draw down of assets from U.S. Compact grant receipts.<sup>8</sup> The recently approved FY2002 Budget targets a substantial fiscal consolidation with a reduction of the deficit to 7 ½ percent of GDP. Price inflation has remained modest (2 ½ percent in FY2001) and slightly lower than in the United States. Public and private sector wages have remained stable since 1996. The current account deficit (including official grants) has been estimated at around 13 percent of GDP in FY2001 and has been projected to increase to 14.8 percent of GDP in FY2002 due to increases in project-related capital goods imports and decreases in tourist receipts.

#### B. Overview of the Financial System and Banking Sector Conditions

27. Palau's financial system consists of 12 commercial banks, including 3 branches of U.S.-based banks, one development bank (the National Development Bank of Palau), 11 nonbank financial institutions, and a number of small credit unions. The three U.S. branches are insured by the FDIC and follow U.S. prudential regulations. One other bank is a branch of an Asian bank, and the remaining eight banks (of which, four are controlled by foreign nationals) are locally chartered. Of the 11 nonbank financial institutions, three are reportedly not in operation and eight provide limited financial services. Offshore banking is not allowed

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<sup>7</sup> See *Republic of Palau—Staff Report for the 2001 Article IV Consultation* (IMF Country Report No. 02/69) and *Republic of Palau—Recent Economic Developments* (IMF Country Report No. 02/70).

<sup>8</sup> The Compact of Free Association with the United States provides Palau with grants totaling nearly \$600 million over 15 years in exchange for U.S. defense control.

in Palau since 1982 when the Offshore Banking Act was repealed. Capital markets are non-existent. No International Business Companies (IBCs) are registered and/or operational in Palau. Table 2 provides a synoptic overview of Palau's banking system.

28. The largest three U.S.-based banks account for approximately 84 percent of total deposits, with the Bank of Hawaii alone accounting for nearly 57 percent of total deposits. These banks place the majority of their deposits at their headquarters in the United States for investment elsewhere. Most of their local loans are in the form of well-secured consumer loans rather than business or commercial loans, which are viewed as more risky and are constrained by a lack of adequate collateral. Other foreign banks with more limited deposit-taking activities in Palau are also mostly engaged in consumer loans, especially to certain ethnic groups. The commercial segment of the market has been taken up by the National Development Bank of Palau (NDBP) which guarantees 90 percent of commercial loans for a fee (the NDBP can also assume the title of land in case of default, something which is very problematic for foreign banks to do).

29. The NDBP's activities of loan guarantee and lending were constrained in 1998/99 by a deterioration of its balance sheet due to poor risk assessment practices. As a result, a new management team was brought in to focus on loan loss recovery and improve credit risk assessment and risk monitoring practices. In 1999, the NDBP extended new loans totaling only \$350,000, which increased in 2000 to \$3.2 million owing to an improvement in its financial position and a government transfer. The current size of NDBP's portfolio is about \$7 million, of which one-third is in residential housing. Loans in arrears (so-called "judgment loans") stand at about \$0.7 million, or 10 percent of total loans.

30. Although financial soundness indicators for the banking sector are not being compiled by the authorities as yet, banking operations in Palau are reportedly profitable owing to the large spread between deposit and lending rates. Deposit rates for the period 1997-2000 on 30-day time savings accounts were in the range 2 ¼-5 percent and on certificates of deposit in the range of 4-8 percent. This compares with lending rates for the same period of between 10-18 percent for consumer loans and 9 ¼-13 percent for commercial loans. A large share of bank lending is consumer loans, which are typically serviced through direct withdrawals from salary deposits. As a result, nonperforming customer loans have historically been very low. Data from corporate reports show an aggregate profit for Palau's nine largest banks.

### **C. The Framework for Supervision and Prudential Regulation**

31. Five key pieces of financial legislation were enacted in June 2001 (with assistance from the Pacific Financial Technical Assistance Center (PFTAC) and LEG) in advance of Palau's review by the Financial Action Task Force (FATF). These, consisted of the Financial Institutions Act (FIA) and four anti-money laundering (AML) laws. In approving the FIA, Parliament diluted the provisions for prudential supervision drafted with LEG assistance, which was justified by the authorities as the only way for obtaining Parliament's approval of the Act.

Table 2. Palau: Banking System  
(In millions of U.S. Dollars as of June 30, 2001)

	Majority Nationality	Percent	Assets	Percent of Total	Loans	Percent of Total	Liquid Assets <sup>1</sup>	Percent of Total	Deposits	Percent of Total	Capital	Percent of Total
<b>Commercial Banks:</b>												
<b>Foreign-Owned Majority:</b>												
Allied Boston Bank <sup>2</sup>	U.S.	90%	1,228.8	87.7%	85.0	57.3%	10.1	10.5%	0.0	0.0%	27.1	60.8%
Bk of Hawaii (Branch) <sup>3</sup>	U.S.	100%	86.6	6.2%	19.7	13.3%	66.8	69.5%	83.5	56.8%	1.5	3.4%
Bk of Guam (Branch) <sup>3</sup>	Guam	100%	26.7	1.9%	11.4	7.7%	1.3	1.4%	26.4	17.9%	0.3	0.7%
BankPacific (Branch) <sup>3</sup>	Guam	100%	13.2	0.9%	1.3	0.9%	0.0	0.0%	13.8	9.4%	-0.7	-1.5%
First Comm. Bk (Branch) <sup>3</sup>	Taiwan	100%	6.4	0.5%	4.3	2.9%	1.8	1.9%	2.4	1.6%	0.6	1.3%
Sunra Intl. Bk & Trust	Japan	45%	4.9	0.3%	4.0	2.7%	0.4	0.4%	0.6	0.4%	4.3	9.7%
Palau Construction Bk	China	100%	3.9	0.3%	2.8	1.9%	0.8	0.8%	2.3	1.6%	1.6	3.6%
First Federal Bk Corp <sup>4</sup>	Taiwan	100%	2.9	0.2%	0.6	0.4%	1.2	1.2%	1.6	1.1%	-0.1	-0.2%
Asia Pacific Comm. Bk <sup>5</sup>	Malaysia	80%	0.0	0.0%	0.0	0.0%	0.0	0.0%	0.0	0.0%	0.0	0.0%
Sub-total:			1,373.4	98.0%	129.1	87.1%	82.4	85.7%	130.6	88.8%	34.6	77.7%
<b>Domestic-Owned Majority:</b>												
Pacific Savings Bk <sup>6</sup>	Palau	64%	13.3	0.9%	11.5	7.8%	8.4	8.7%	12.1	8.2%	1.1	2.5%
Bk of Palau	Palau	100%	2.8	0.2%	2.5	1.7%	0.0	0.0%	3.6	2.4%	-1.0	-2.2%
Melekeok Govt. Bk <sup>7</sup>	Govt.	100%	1.1	0.1%	0.3	0.2%	0.1	0.1%	0.8	0.5%	-0.4	-0.8%
Sub-total:			17.2	1.2%	14.3	9.6%	8.5	8.8%	16.5	11.2%	-0.3	-0.6%
Total Commercial Banks:			1,390.6	99.3%	143.4	96.7%	90.9	94.6%	147.1	100.0%	34.4	77.1%
<b>Development Banks:</b>												
Natl. Devl. Bk of Palau <sup>8</sup>	Govt.	100%	10.2	0.7%	4.9	3.3%	5.2	5.4%	0.0	0.0%	10.2	22.9%
<b>Total Banking System</b>			1,400.8	100.0%	148.3	100.0%	96.1	100.0%	147.1	100.0%	44.6	100.0%

Source: Interim Financial Institutions Regulatory Advisory Panel.

Notes:

<sup>1</sup>Includes cash on hand, balances due from other banks, and other short term liquid assets (i.e., money market investments).

<sup>2</sup>Bank reports no deposit liabilities, but reports borrowings and other current liabilities of \$1.178 billion, legal proceedings have been initiated by the Attorney General's Office challenging the status of this institution as a "bank" defined in the Financial Institutions Act 2001.

<sup>3</sup>For branch banks, capital represents the difference between reported assets and liabilities.

<sup>4</sup>A wholly owned subsidiary of a foreign banking corporation.

<sup>5</sup>As of June 30, 2001, bank had not commenced operations.

<sup>6</sup>Information submitted by Pacific Savings Bank, data as of December 31, 2001.

<sup>7</sup>Wholly-owned by the State of Melekeok, Republic of Palau.

<sup>8</sup>Information submitted by National Development Bank of Palau. Bank is wholly owned by the government of the Republic of Palau and does not currently accept deposits from the public.

32. The FIA established the Financial Institutions Commission (FIC) as the agency to oversee banking regulation and supervision and, more generally, to oversee implementation of the FIA's provisions. Notably, the FIA had set forth a deadline on all banks operating in Palau at the time of the FIA's enactment to apply for a banking license under "grandfathering" provisions—that is, by just complying with minimal statutory requirements established in the FIA—by December 17, 2001.<sup>9</sup> However, due to the considerable delay in the constitution of the FIC,<sup>10</sup> including the appointment of an Executive Commissioner and a permanent staff, the President of the Republic of Palau had to appoint, with Executive Order, an Interim Financial Institutions Regulatory Panel (Panel)—consisting of a Coordinator and three members—to be the focal point for the implementation of the FIA, including with regard to the enforcement of the "grandfathering" deadline. Moreover, the FIA did not establish proper prudential evaluation of existing banks and grants exemptions to the statutory capital requirements to those banks under the "grandfathering" provisions.<sup>11</sup>

33. The FIC was established on February 21, 2002 (some eight months after the FIA was enacted in June 2001), when four of the five voting members of its GB—chosen by the President from a list of ten names submitted by the Chamber of Commerce—were formally confirmed by the Senate. The Chair and Vice-Chair of the GB are representatives from the business community, while the other two voting members are bankers (representing one domestic and one foreign private commercial bank, respectively). The President of the state-owned National Development Bank of Palau is, *ex-officio*, the sixth non-voting member of the GB.

#### **D. Anti-Money Laundering Measures**

34. A number of implementation measures were put in place by the Office of the Attorney General (AG) of Palau following the enactment of a package of four AML laws in June 2001. These have provided for the establishment of a Financial Intelligence Unit (FIU) under the AG and the notification given to banks and other financial institutions mandating them to submit to the FIU a "Suspicious Transactions Report" under specific circumstances.

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<sup>9</sup> This deadline was subsequently extended to February 15, 2002.

<sup>10</sup> The delay was caused by disaccording views on the composition of the FIC's Governing Board.

<sup>11</sup> Twelve existing banking institutions applied to the FIC for a banking license under the "grandfathering" provisions of the FIA.

Additionally, the licenses of 10 shell corporations which had been registered as banks were revoked around September 2001 and notices in this regard were sent to the U.S. Office of the Comptroller of the Currency and the FDIC.<sup>12</sup>

35. Palau has become a signatory to Pacific Island Forum anti-money laundering initiatives, notably the Honiara Declaration, which calls for Forum member countries to implement the FATF 40 Recommendations. In their ongoing dialogue with PFTAC, the authorities have expressed their commitment to continue to implement the FATF's 40 Recommendations and have requested further assistance to strengthen the legal framework, as well as their implementation capabilities for the combating of money laundering and the financing of terrorism.

### **E. Previous Reviews**

36. This is the first formal MAE visit to Palau, although the authorities maintain an ongoing dialogue with PFTAC and have been assigned by MAE a Banking Supervision Advisor on a peripatetic basis in FY2002. The Republic of Palau is *not* on the FATF's NCCT list of non-cooperative jurisdictions as a result of a review of Palau's legislation conducted by a FATF mission in September 2001.

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<sup>12</sup> The U.S. Department of State, in its "*Money Laundering and Financial Crimes Report, 2000*" had raised concern over Palau's licensing of such shell banks, which were alleged to have handled almost \$2 billion in suspicious transactions with foreign financial entities.



APPENDIX II

**PALAU: TECHNICAL ASSISTANCE PROGRAM IN BANKING SUPERVISION  
AND PRUDENTIAL REGULATION**

**FOR CALENDAR YEAR 2002 AND SUBSEQUENT PERIODS**

	SCHEDULE/DURATION OF VISITS				
	2 <sup>nd</sup> Quarter 2002	3 <sup>rd</sup> Quarter 2002	4 <sup>th</sup> Quarter 2002	1 <sup>st</sup> Quarter 2003	Future TA Projects
<b>DESCRIPTION OF TECHNICAL ASSISTANCE ACTIVITIES</b>	40 days	60 days	40 days	60 days	
<b>STRENGTHENING THE SUPERVISORY AND REGULATORY FRAMEWORK:</b>					
1. Draft and issue regulation establishing statistical data and other information (regulatory reports) to be submitted by banks to FIC, including: <ul style="list-style-type: none"> <li>- Develop report format and supporting schedules to be utilized by banks in submission of data and other information;</li> <li>- Develop instructions for the completion of regulatory reports and supporting schedules consistent with GAAP – include requirement that books and records of banks must be maintained in accordance with accounting requirements outlined in regulatory reporting instructions;</li> <li>- Incorporate reporting requirement on transactions with related persons and loans in excess of 10% of capital to evaluate compliance with relevant provisions of FIA.</li> </ul>	✓				
2. Establish off-site monitoring procedures to review, analyze and assess operating performance and condition of banks and the overall banking industry, including: <ul style="list-style-type: none"> <li>- Development of off-site monitoring procedures and responsibilities, preparation of off-site monitoring summary reports, recommendations for addressing noted weaknesses/concerns, and review/approval of off-site monitoring by Executive Commissioner;</li> <li>- Identify selected “key” ratios encompassing capital adequacy, asset quality, earnings performance and liquidity to assess condition of banks and overall banking industry;</li> <li>- Development/establishment of “data base” for maintenance of current and historical (level and trends) statistical data and automated calculation of key ratio and selected levels and trends.</li> </ul>		✓			
3. Conduct analysis to determine the condition, operating performance, and compliance with FIA requirements of existing banking institutions.		✓	✓		
4. Develop and issue guidelines establishing licensing		✓	✓		

<p>criteria for new banking institutions (including identification of beneficial owners), procedures on licensing and necessary forms:</p> <ul style="list-style-type: none"> <li>- Develop/issue regulation on preparation and minimum content requirements for business plan and pro forma balance sheet and income and expense statements.</li> </ul>					
<p>5. Develop and issue regulation on minimum criteria for entry of new significant shareholders (including change-of control) and minimum time frame for notifying and submitting necessary information to FIC staff.</p>			✓		
<p>6. Develop and issue prudential regulations as specifically provided in FIA:</p> <ul style="list-style-type: none"> <li>- Definition and computation of regulatory capital, risk-based capital, and risk-weighted assets;</li> <li>- Calculation of credit exposure to single borrowers and related groups, including aggregation and attribution requirements;</li> <li>- Asset classification definitions, minimum provision requirements for classified assets, and placement of nonperforming loans on nonaccrual status.</li> </ul>		✓			
<p>7. Develop and issue guidelines on prudential practices on credit polices, asset quality, and other requirements as necessary based on local banking practices, conditions and legal constraints.</p>	✓	✓	✓	✓	✓
<p>8. Develop amendment providing for increased funding of FIC – recover expense of supervision through assessment of fees for on-site examinations and assessment of fees for on-going normal operations of FIC, including salaries of FIC staff.</p> <ul style="list-style-type: none"> <li>- Assist in staffing requirements/plan and budgetary process.</li> </ul>				✓	✓
<p>9. Develop regulations as necessary to clarify application or to properly implement FIA:</p> <ul style="list-style-type: none"> <li>- Require existing banks to provide information as to beneficial owners;</li> <li>- “Loans” on books of existing banks includes “credit” as defined in FIA for purposes of determining compliance with limit on credit extended to single and related borrowers;</li> <li>- Establish minimum time frame for notifying FIC staff of pending change-of-control, merger, or sale of substantially all assets of a bank;</li> <li>- Establish procedures for compliance with conflict of interests by banks;</li> <li>- Clarify applicability of FIA to other corporations undertaking financial activities (other than deposit taking activity).</li> </ul>	✓	✓	✓	✓	✓
<p>10. Develop and issue guidelines on minimum criteria to evaluate adequacy of internal audit procedures of banking institutions.</p>				✓	✓
<p>11. Review anti-money laundering laws and regulations and assist in promulgation of necessary regulations for banks, including “know your customer” requirements.</p>		✓			

<p>12. Develop guidelines for use by FIC for conducting on-site safety and soundness examinations of banks, including:</p> <ul style="list-style-type: none"> <li>- Establishing operating policy for FIC on minimum examination frequency and prioritization;</li> <li>- Examination procedures for functional areas, compliance with requirements of FIA, and assessment of performance of administrators;</li> <li>- Develop standardized examination report format, supporting schedules and key ratios.</li> </ul>				✓	✓
<p>13. Develop guidelines/procedures for assessing adequacy of administrators and their performance and criteria for acceptability of persons appointed as administrators.</p> <ul style="list-style-type: none"> <li>- Removal of administrators to be addressed and included in regulation for enforcement actions.</li> </ul>				✓	✓
<p>14. Develop guideline for use by FIC on uniform bank rating (internal assessment tool for use by FIC staff for rating the performance and condition of the CAMELS components and overall condition of a bank), including establishing benchmarks for ratings of each component.</p>				✓	✓
<p>15. Develop and issue guideline/regulation on enforcement actions, identifying types of enforcement measures (written agreements, orders, suspension of administrators and officers and suspension/revocation of banking license), procedures for preparation, issuance and appeal process.</p> <ul style="list-style-type: none"> <li>- Develop separate regulation on calculation and assessment of monetary penalties including criteria to determine appropriateness and amount of penalty.</li> </ul>				✓	✓
<p>16. Develop regulation specifying nature and type of information that may be released as “public information” and minimum public disclosure of financial information of banks:</p> <ul style="list-style-type: none"> <li>- Formulate formal written agreement for sharing of information with other bank supervisory authorities to assure confidentiality of information.</li> </ul>				✓	✓
<p><b>DEVELOPING IMPLEMENTATION CAPABILITIES:</b></p> <p>17. Provide hands-on training in off-site monitoring, including:</p> <ul style="list-style-type: none"> <li>- Review of regulatory reports for completeness and identification of suspicious changes;</li> <li>- Calculation and analysis (meaning) of key ratios, and use of levels and trends analysis techniques for each of CAMELS components (capital, asset quality, management, earnings, liquidity and sensitivity to market risk);</li> <li>- Checks for compliance with FIA and regulations; and</li> <li>- Preparation of off-site monitoring/summary reports.</li> </ul>	✓	✓	✓	✓	✓
<p>18. Assist with and provide hands-on training in evaluation of applications for banking licenses – including the review of financial statements on proposed principal shareholders, adequacy of business plans and pro forma statements (assumptions), and proper use of conditions on the license of a bank.</p>			✓	✓	✓

<p>19. Provide assistance/training to Governing Board of FIC as needed, including:</p> <ul style="list-style-type: none"> <li>- Role of Governing Board versus Executive Commissioner and staff in day-to-day activities;</li> <li>- Format and content of reports required to be submitted by the Executive Commissioner to the Governing Board;</li> <li>- Identification of duties which the Executive Commissioner may assign to FIC staff;</li> <li>- Attend meeting of Governing Board when available;</li> <li>- Other areas as requested or identified.</li> </ul>	✓	✓	✓	✓	✓
<p>20. Conduct briefing sessions with Governing Board, Executive Commissioner, FIC staff and representatives of banking industry as necessary or requested to assure proper implementation of provisions of FIA and regulations or guidelines (proposed or issued) by FIC:</p> <ul style="list-style-type: none"> <li>- Provide training to Executive Commissioner and staff regarding proper use of “discretion” in enforcing provisions of the FIA and regulations.</li> </ul>	✓	✓	✓	✓	✓
<p>21. Provide training to Governing Board, Executive Commissioner, FIC staff as needed regarding functional areas of bank operations to facilities thorough and efficient examinations (both on and off-site).</p>	✓	✓	✓	✓	✓
<p>22. Provide training/assistance in the examination of banks (both on and off-site) and analysis and preparation of examination reports, including”</p> <ul style="list-style-type: none"> <li>- Assessment of CAMELS components and relevant key ratios; and</li> <li>- Loan portfolio analysis techniques, including use and analysis of financial statement ratios, structuring and other considerations for different types of loans, and techniques to assess the adequacy of provisions for bad loans.</li> </ul>		✓	✓	✓	✓
<p>23. Provide training on proper use of enforcement actions (written agreements, cease and desist orders, suspension of administrators and officers and suspension/revocation of banking license), including:</p> <ul style="list-style-type: none"> <li>- Content of enforcement action to address weaknesses or concerns;</li> <li>- Issuance of enforcement action; and</li> <li>- Monitoring of compliance with enforcement action.</li> </ul>		✓	✓	✓	✓
<p>24. Provide training on GAAP and regulatory accounting practices in accounting for assets, liabilities and income and expense items.</p>	✓	✓	✓	✓	✓