



IMF Policy Discussion Paper

Financial Sector Regulation and Supervision: The Case of Small Pacific Island Countries

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Asia and Pacific Department

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Abstract

<p>The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.</p>

This paper discusses issues of financial sector regulation and supervision--including those concerning nonbank financial intermediaries--in small resource-constrained Pacific island countries. It advocates stronger cooperation in these areas and calls for increased financial and technical assistance. The paper also reviews recent international initiatives directed toward offshore financial centers and the fight against money laundering and other financial crime and explores their significance for the Pacific island countries.

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I. INTRODUCTION

1. Financial sector soundness and stability has emerged as one of the principal themes of economic policy and international cooperation in the world. It encompasses a whole range of subject areas, including in the first place the traditional concern about the appropriate regulation and effective supervision of banks. Increasing attention has over the past decade also been given to measures to ensure the soundness of nonbank financial intermediaries such as development banks, provident funds and insurance companies. More recently, the attention of both international organizations and national authorities has been drawn to the operations, financial impact and prudential issues of offshore financial centers, including their role in the growing problem of tax evasion and money laundering.

2. The present paper seeks to look at these issues from the perspective of the Pacific island countries (PICs) in order to inform the authorities of PICs about the nature and implications of these international developments and allow them to prepare appropriate action in their own countries and regionally to ensure that they will remain an integrated and respected part of the international financial community. In connection with this assessment, the paper will report on a recent initiative to strengthen regional cooperation and coordination in financial sector regulation and supervision and indicate a number of areas in need of further action.

II. BANKING REGULATION AND SUPERVISION

3. In a number of Pacific island countries (PICs), considerable efforts have been made over the past 10-15 years to establish a supervisory capacity for the banking sector within a clearly defined legal structure, formulate an appropriate regulatory framework, and implement the supervision of banking institutions in line with international standards.¹ During the initial stages, these efforts were primarily supported by technical assistance from the International Monetary Fund. Later, the main assistance came from the Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji.²

¹ Pacific island countries having established a supervisory capacity either in the central bank or separately include: Federated States of Micronesia, Fiji Islands, Republic of the Marshall Islands, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu. Palau has recently passed a general Financial Institutions Act and is now in the process of establishing a supervisory body (Financial Institutions Commission).

² PFTAC is a multi-donor supported institution, including the IMF as Executing Agency and UNDP, AsDB, Australia and New Zealand as donors. The Centre serves 15 Pacific island countries (Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu) with technical assistance in economic and financial management.

4. Assistance by PFTAC took the form of regular visits by the Centre's Banking Advisor and systematic follow-up on earlier advice, but also included in-country training and workshops, regional seminars, the arrangement of attachments to sister institutions in the region, and advice and guidance through direct communication from the Centre. In virtually all countries with supervisory authorities, the Advisor has played a major role in the drafting and subsequent adaptation of financial institutions legislation, as well as in the establishment of regulation and supervisory practices in line with the evolving international "best practices," notably the *Core Principles for Effective Banking Supervision* developed by the Basel Committee.

5. Despite significant progress in those PICs that have established banking regulation and supervision capacities, there are substantial pressures mainly from two sides that could cast doubts on their ability to fully meet international standards. The first derives from the fact that the amount of financial and human resources which PICs can devote to this area of economic and financial management remains rather limited even under the best of circumstances, but especially so in the smaller PICs. In addition, the growing integration of financial sectors worldwide, in combination with the increasing sophistication of financial instruments and their accounting and supervision needs, require a breadth and depth of skills which it is difficult to believe many of the PICs could develop on their own.

6. In this environment, the idea of establishing a regional capacity for banking regulation and supervision has come up on a number of occasions but without much of a follow up until 1998 when several Governors of central banks in PICs encouraged PFTAC to examine the issues involved. In an analytical paper entitled *The Case for a Regional Supervisory Agency for Pacific Island Countries*, the Centre focused on the following questions: Firstly, is a regional agency likely to achieve a higher quality of supervision than individual country institutions? Secondly, is such an agency likely to be more cost effective? Thirdly, is it more likely to be objective in its examination and advice, as well as independent politically than individual country agencies? Fourthly, would a regional agency be better suited to offer supplementary services such as the supervision of specialized financial institutions and services, the establishment and maintenance of an information base on rating of institutions and their management, financial scams, and other risk parameters? And, finally, could the establishment of a Regional Supervisory Agency (RSA) facilitate the move of PICs toward harmonized legislative and regulatory arrangements in the region in line with international standards, and thereby assist in the integration of regional financial sectors and economies into the world economy.

7. The results of the study indicated that there was, indeed, a strong case for the establishment of a regional supervisory capacity. However, as the move toward a RSA is unlikely to be achievable over the foreseeable future and in one step, if at all, a companion paper entitled *Financial Sector Regulation and Supervision in the Pacific Countries: The Case for Closer Cooperation and Coordination* developed a program for increased regional cooperation and coordination in banking supervision. The two papers were discussed during the *South Pacific Central Bank Governors Meeting* in Sydney in December 1998 and the suggestions was made that the regional heads of supervision should develop practical steps

for closer cooperation for consideration at the next *Governors Meeting*. In response, PFTAC organized in June 1999 a *Meeting of the Regional Heads of Supervision* in collaboration with the Reserve Bank of Fiji. Discussions during the meeting revealed that some informal contacts between supervisory authorities already existed. However, it was felt that these could be strengthened and formalized in a number of areas and that this could best be done in the form of a **Declaration on Cooperation** by the highest authorities responsible for financial sector regulation and supervision in their respective countries. Consequently, a *Draft Declaration* was prepared for consideration by the national authorities and an eventual formal endorsement in the context of the *South Pacific Central Bank Governors Meeting* in Wellington in December 1999. PFTAC was elected to serve as a Secretariat in this process.

8. In early 2000, the authorities of all countries that already had established national supervisory agencies and regimes signaled support for the broad objective of increased cooperation and coordination, including the two Micronesian countries, Federated States of Micronesia and Republic of the Marshall Islands, which do not have a central bank and own currency. As a result, a press release was issued by PFTAC, which announced the establishment of the **Pacific Islands Prudential Regulation and Supervision Initiative (PIPRSI)** as part of the official *Declaration on Cooperation*.³

9. The Initiative builds on the observation that, despite significant progress in their regulatory systems and supervision over the last decade, Pacific island countries remain vulnerable to financial sector volatility and illicit financial operations, including money laundering. The members of the Initiative therefore decided to reinforce their commitment to financial sector soundness and stability. This will in the first place include a further strengthening of their domestic regulatory environment and supervision practices in correspondence with international best practice. In addition, it will include a commitment to the establishment of more formal and extensive arrangements for closer cooperation and coordination among the members of the Initiative.

10. The press release and publication of the *Declaration on Cooperation* resulted in a wide and very positive reaction of regional and even international media not least because it confirmed the commitment of the authorities involved in the Initiative to take their responsibilities seriously. While not removing the structural regional impediments to achieving supervision at international standards (which appear to call for a regional capacity) it is quite clear that the Initiative can be an effective means for strengthening regulatory and supervisory activities in the region and thereby increase the credibility and reputation of banking and other financial sector activities. Important for this result will be the full and sustained support for the Initiative from the national authorities. In this case, all countries in the region will benefit in a number of ways, including in the form of improved credit ratings.

³ For the *Declaration on Cooperation*, see Appendix I. Note in this context that the term “undersigned parties” is not quite correct, as no official signing took place, given the administrative complications of it.

11. The development of the Initiative has so far taken place within the framework of the *South Pacific Central Bank Governors Meeting* and the *Meeting of the Regional Heads of Supervision* in connection with PFTAC's regional activities in the area of financial sector regulation and supervision. There does not appear to be an immediate need to establish a different framework because, although not formally covering all PICs, this format does not preclude PICs which share the objectives of the Initiative and are committed to sound banking and supervisory practices to join the Initiative. Indeed, the Initiative invites all those PICs not yet associated with it to join. Nor would it appear to be necessary or desirable at this stage to broaden the realm of the Initiative toward more general financial sector issues, or even wider security issues. However, it would be desirable to ensure close coordination and compatibility of regional efforts in those areas that focus on economic and financial soundness and stability.⁴

III. NONBANK FINANCIAL INTERMEDIARIES

12. Financial sector regulation and supervision initially focused on banks and other deposit-taking institutions because its original objective was the protection of depositors. With the increasing integration of financial sectors and development of new financial institutions and instruments, however, it was recognized that failure of any one of them can create substantial financial and economic instability and cause large income and welfare losses. Viewed from this perspective, soundness of operations therefore needed to be made an objective for all financial institutions, and appropriate rules and mechanisms to achieve, monitor, and sustain it needed to be put in place. The initial rationale for banking supervision, i.e. the protection of depositors, was therefore increasingly replaced by the more comprehensive rationale of preserving stability in key financial institutions and the financial system as a whole.

13. In the Pacific island countries a number of nonbank financial institutions have emerged, and some of them have a very substantial weight in the economy. This applies especially to provident funds, the lending of which at times exceeds that of many commercial banks and sometimes approaches the aggregate weight of lending by commercial banks. Other nonbank financial institutions like development banks also play an often significant role in PICs and have, at times, given rise to concern.⁵ Existing legislation and oversight arrangements for these institutions have proved inadequate in most cases, and a number of serious problems have occurred that undermined the stability or even the very existence of individual institutions. As a result, calls for their effective supervision have increasingly been

⁴ In addition to regional support mechanisms, there is a need to strengthen internal governance of financial institutions. Moreover, more extensive use could be made of commercial auditors where domestic supervisory capacity is inadequate.

⁵ In the case of development banks, a key problem often is excessive political interference incompatible with sound financial principles.

advanced both internally and on the part of international institutions or bilateral donors concerned about the soundness and effectiveness of their operations and the stability of the financial sector as a whole.

14. The problem with these calls has been that, already, most supervisory authorities in the region are overwhelmed by the demands the supervision of the banking sector places on them. An expansion of their responsibilities to nonbank financial intermediaries would in some cases severely dilute and seriously weaken their principal activities, especially if the supervision of large numbers of institutions such as credit unions would be required, as is under consideration in the Solomon Islands. In most PICs it is doubtful that the necessary expertise for the supervision of specialized financial institutions can be built even over a reasonable period of time—or can be built at all! As a result, some supervisory authorities are reluctant, or even hostile, to the idea of assuming responsibilities for additional financial institutions—and be held responsible for their soundness.

15. If there is a case for a regional capacity in financial sector regulation and supervision, it would appear to be particularly strong in the area of nonbank financial institutions where it is inconceivable that, with the exception, perhaps, of the largest PICs, an effective and sound national capacity can be generated. Ideally, supervision of these institutions would therefore be as part of a Regional Supervisory Authority of the type discussed above. However, since its establishment is uncertain—and may be far down the road in any event—imaginative solutions will have to be found in the interim to ensure the sound operations of these institutions. Preferably, these should build on the understanding that a regional approach will ultimately yield the best results in terms of costs, harmonization, and effectiveness.

16. One regional solution could be for PICs to seek, as a group, the assistance from those countries in the region which have already established a capacity of solid reputation in these areas of supervision. This is certainly the case for the Australian Prudential Regulation Authority and its New Zealand equivalent. If this was to become the agreed approach, these institutions would probably need to establish a supplementary capacity for their services to PICs, raising the issue of organization and costs. Regarding organization, consideration could be given in the assisting countries to the assignment and integration of these activities under the heading “development assistance.” As far as costs are concerned, two approaches could be explored. One would be to charge the countries requesting the service individually on the basis of the costs by type of institution and country. Another could be to explore whether such services could be financed under a regional financial assistance plan, combined with a regular examination schedule and a remedial action plan, where needed to ensure continued soundness and stability. Consideration may also have to be given to charging the supervised institutions. If none of the regional options can be made operational, some form of supervision will still be needed, and most countries should in this case probably seek assistance from reputable commercial audit companies or accounting firms rather than

attempt to build local capacities.⁶ As in the case of a regional solution, enforcement of required remedial action would, however, still have to be assured by the national authorities.

IV. OFFSHORE FINANCIAL CENTERS

17. No area of financial sector regulation and supervision has over the past two years received as much international attention as the operations of Offshore Financial Centers (OFCs). For a long time—when their number was still limited—these OFCs were considered to provide useful services in an increasingly integrated world because, with their simplified tax, incorporation, foreign exchange, and supervisory regimes, they would help reduce the complications of often overbearing and complex national legislation. From the perspective of offshore banks and commercial enterprises, other advantages of OFCs often included lower tax rates, less demanding regulations and controls, and anonymity. It was primarily these latter attributes which resulted in a sharp increase in the share of financial and commercial activities conducted through an increasing number of OFCs. In parallel with this development, and with the intention to maximize their profit, banks and companies often engaged in a fierce “arbitrage” between OFCs and thereby put them under pressure to lower their costs and standards. Alternatively, banks and companies approached willing governments to grant offshore licenses under conditions which the principal OFCs were not willing to accept.

18. The mushrooming of these practices and continued increase in the number of OFC's worldwide has resulted in growing concerns of governments and international financial institutions (IFIs) about the implications of these developments for such critical areas of economic policy as financial stability, the integrity and effectiveness of national tax systems, transparency and accountability, and the general avoidance of illegal activities. In September 1999, the Communiqué of the International Monetary Fund's Interim Committee stated that: *“In the financial area, governments must maintain strong internal financial controls and tighten supervision and regulation of domestic financial institutions and offshore centers, including measures to deter money laundering.”* In January 2000, the G-7 Finance Ministers and Governors Communiqué went beyond this call by stating: *“In order to secure the benefits of the global financial system, we must ensure that its credibility and integrity are not undermined by crime, poor regulatory standards and harmful tax competition. We remain concerned about offshore havens which undermine international standards of financial regulation and which are shelters to avoid or evade payment of tax.”*

19. There are now more than a dozen initiatives ongoing worldwide that aim at curbing OFC involvement in lax financial regulation, tax evasion, and financial crime. They include

⁶ Countries without an adequate supervisory capacity for nonbank financial intermediaries, or access to “outsourcing” options, should probably consider not granting a license at all, except where the reputation of the company ensures strong internal governance and sound business practices.

such diverse initiatives as the *Asia-Pacific Group on Money Laundering*, the *Basel Committee*, the *Offshore Group of Banking Supervisors*, the *Financial Action Task Force (FATF)*, the *Financial Stability Forum*, and the *United Nations Office on Drug Control and Crime Prevention (UNODCCP)*. The role of the IMF in this somewhat amorphous area, that includes issues ranging from financial sector stability to its regulation and supervision and even the prevention of crimes and law enforcement, is still evolving.⁷ However, the IMF has assumed the role of undertaking comprehensive assessments of financial supervision in OFCs, and of providing advice and technical assistance. More generally, the IMF has favored a participatory and consultative process; its assessments are voluntary and reports can be published if the country so wishes.⁸ In line with its core responsibilities, the IMF is giving particular attention to compliance with international standards and the identification of vulnerabilities in the financial system as well as assessments of the robustness of supervision. Efforts are under way to integrate these activities into such broader IMF initiatives as the *Financial Sector Assessment Program (FSAP)* and the *Reports on the Observance of Standards and Codes (ROSC)*. It is important to note in the context of the work on OFCs that these initiatives do not take a one-sided look only at the situation in countries hosting OFCs. Instead, most of them acknowledge explicitly the responsibility of “home” countries to address these issues in their own jurisdiction.⁹

20. The concept of shared responsibility is most explicitly incorporated in the Basel Committee’s active promotion of effective cooperation between “home” and “host” authorities and supervisors in the area of offshore banking.¹⁰ Minimum standards for such cooperation are part of the Committee’s *Core Principles* under the heading of “Supervision of International Banking Groups and their Cross-Border Establishments.” These minimum standards define the responsibilities of both “home” and “host” supervisors and also include critical provisions for gathering and sharing information on the activities of cross-border establishments. Especially the latter call into question any existing secrecy provisions.

21. Among the Pacific island countries, the Cook Islands, Nauru, Niue, Samoa, Tonga, and Vanuatu have OFCs or have otherwise licensed offshore banks and companies. Of these, only Samoa and Vanuatu, and occasionally Tonga, have requested and received technical

⁷ Compare <http://www.imf.org/external/np/sec/nb///2000/nb0062.htm> covering the IMF News Brief 00/62 of July 26, 2000.

⁸ A progress report on the IMF’s work so far can be found on the Fund website (<http://www.imf.org/np/mae/oshore/2001/eng/062901.htm>) July 18, 2001.

⁹ A “home” country is the country in which a bank or other financial institution or company is incorporated and licensed, while a “host” country is the jurisdiction in which the bank or company has obtained a license for activities requiring official authorization.

¹⁰ The concept of “home” and “host” does not apply to most other offshore operations.

assistance in legislation, regulation and supervision of their offshore banking institutions from PFTAC or the IMF. In particular, the Centre's Banking Advisor has worked together with the authorities of the first two countries to strengthen regulation and supervision of offshore banks and encouraged them to meet the standards of the *Offshore Group of Banking Supervisors* (OGBS), which works closely with the Basel Committee on the establishment and implementation of sound prudential practices.

22. There is no doubt that the growing international concern about offshore banking operations will exercise increasing pressure on the operations of OFCs in the Pacific region and elsewhere. Already, a number of PICs have been included in the group of "non-cooperative countries and territories" (NCCTs) of the Paris-based Financial Action Task Force (FATF) and been threatened with sanctions if their regulatory environment and supervisory practices remain inadequate to fight money laundering.¹¹ There is also no doubt that this concern is not a temporary phenomenon but will increasingly shape the debate and actions of international organizations and determine the characteristics of supervisory regimes and practices considered necessary for sound and legitimate offshore operations.¹² It will therefore be important for the PICs hosting OFCs or otherwise permitting offshore activities to understand these developments, assess their likely impact, and prepare appropriate action that will ensure compatibility with international standards and preservation of their countries' reputation, as well as that of the region as a whole.¹³

23. In the assessment of compatibility with international standards and practices, four constituting requirements will be examined with special attention by the various agencies that may be involved in the process: (i) the presence of a suitable legislative and regulatory framework; (ii) the strong and unwavering commitment of the authorities to the implementation of this framework; (iii) the capacity of supervisory agencies to effectively implement the framework and its various stipulations; and (iv) appropriate legal/criminal enforcement. In addition, attention will be given to the willingness of "home" and "host" countries to cooperate and share information on critical financial operations and operators.

¹¹ The initial list of fifteen countries listed by the FATF included also the four PICs of Cook Islands, Marshall Islands, Nauru, and Niue. The Cook Islands, Nauru and Niue are not IMF members.

¹² The recent international initiatives against terrorism will without doubt further strengthen the resolve of the international community to fight money laundering.

¹³ The Republic of the Marshall Islands has recently repealed a provision in the Banking Act permitting offshore banking. While offshore trust funds are permitted, currently no such funds are registered. Its offshore operations concentrate on "flag of convenience" shipping operations and related services. Tonga is in the process of repealing its Offshore Banking Act but already has no offshore banks licensed. It has recently been taken off the "Tax Haven" list of the OECD.

24. It is quite clear that these developments will have a profound impact on virtually all OFCs around the world and will in most of them require very substantial adjustments in legislation and regulation, as well as in supervisory capacities and practices, including in PICs with OFCs or less formalized offshore operations. At the same time, there are indications that a considerable number of offshore banks and companies currently operating in OFCs around the world will neither be prepared nor be able to meet the higher new standards for supervision and information that will become the norm for supervisory agencies around the world. Chances therefore are that the sound and legitimate offshore financial operations will be conducted in OFCs willing to commit to high international standards and capable of enforcing them. For the rest, non-enforcement of stricter standards is likely to imply international sanctions, while even partial enforcement may lead to a substantial reduction in their business.

25. This likely scenario suggests that OFCs in the region—as those elsewhere—will on the one hand face very substantial costs related to the unavoidable upgrading of their legal and enforcement systems while at the same time facing the prospect of a sharp decline in the number of their customers, as well as the income from license fees and/or other revenue related to offshore activities. While this scissors movement of costs and return is not in doubt, the specific country situation can only be assessed by a careful examination of, on the one hand, the adjustments needed to implement the necessary reform and, on the other hand, the likely rate of withdrawal of banks and companies as a result of higher standards in the supervisory regime. Depending on the situation, the net balance of such a development may well be negative. In this case, the abandonment of offshore operations is the best solution, especially if it helps restore confidence and reputation and ensures the good will and cooperation of “home” countries committed to high standards. To ensure that no unnecessary resources are spent on any upgrading of the supervisory framework and institutions, such an assessment should be undertaken before a decision is made in favor of such changes.

26. Offshore banking is a special area of banking regulation and supervision, not only because of its very nature but also because countries tend to see each other as competitors. This is not wrong but can be hazardous when this competition includes the absence or negligence of due diligence in supervision as an element to attract foreign banks and enterprises. In the end, this kind of competition serves no one. Efforts should therefore be made by individual PICs, and regionally, to prepare for full cooperation with those international efforts and institutions that seek to curb offshore activities of a dubious or even illicit character while encouraging the application of “best practices” for activities that are legitimate and do not undermine the stability, soundness, and transparency of financial operations at home, in the Pacific region, and in the global economy. At the same time, international initiatives must recognize the extremely limited resources available in PICs and therefore make an effort to find solutions that are simple and do not impose excessive opportunity costs in terms of human resources.

V. MONEY LAUNDERING AND OTHER FINANCIAL CRIMES

27. Although frequently linked to offshore operations, money laundering can take a wide variety of forms and its prevention may require close cooperation and concerted action on the part of a great number of national and international institutions. Because the money involved originates from criminal activity, money laundering relies on secrecy and the circumvention of all those institutions and regulations that support the rule of law and strengthen transparency and accountability. This makes it difficult to trace these activities and decide where action is needed. Money laundering can even take place outside the jurisdiction of the "host" country but still be linked to it when the name of the country, or that of a bank and company licensed by the country, can be used elsewhere to document and "legitimize" a transaction.

28. Highly sophisticated intelligence and policing operations may therefore be needed in order to control, and eventually eradicate, money laundering. These capacities are unlikely to be available in PICs, nor would it appear realistic, promising, and cost-effective to establish them on a country-by-country basis. This does not mean, however, that individual PICs cannot do anything. First of all, they can set up a broad framework legislation that makes money laundering and similar activities punishable by law.¹⁴ Secondly, a broad-based program to improve the transparency of government and private sector operations, as well as the installation of processes to monitor, assess and share this information, will be needed to limit the scope for such activities.

29. Initiatives of this sort at a domestic level need to be complemented by action and agreements at an international level. During a recent meeting of the *United Nations Office of Drug Control and Crime Prevention*, three fundamental elements were advanced: (i) a political commitment by governments to the implementation of minimum performance standards; (ii) a program of technical assistance and training; and (iii) research and information gathering, including the dissemination of results to the competent national authorities. It would appear that a principal responsibility for such action in cases of cross-border transactions would be on the part of "home" countries, with "host" countries primarily ensuring the existence of an appropriate legislative and regulatory environment and engaging in a commitment to full cooperation with "home" countries and international bodies involved in the eradication of financial crime.

30. The increasing importance attached to the fight against financial crime is also reflected by the fact that the IMF has been asked to address this issue and enhance its contribution to ongoing international efforts in this area. In its meeting on April 13, 2001, the Fund's Executive Board considered money laundering "*a problem of global concern*" the

¹⁴ Draft model laws to that effect have been prepared by the Commonwealth Secretariat: *Draft Model Law for the Prohibition of Money Laundering*; April 1995; and the United Nations: *UNDCP Model Money-Laundering and Proceeds of Crime Bill 1998*.

breadth and cross-cutting nature of which called for "a cooperative approach among many different international institutions".¹⁵ In these efforts, the IMF will primarily play a role in protecting the stability and soundness of the international financial system, including efforts to strengthen anti money laundering elements in relevant supervisory regimes and principles, while the lead in the implementation of anti-money laundering efforts will have to be taken by specialized agencies such as the *Financial Action Task Force* and international law enforcement agencies such as *Interpol*.¹⁶ Indirect efforts by the IMF and other institutions like the Basel Committee will involve the strengthening of financial sector regulation and supervision, as well as the expansion and improvement of financial statistics. The need for an increase in technical assistance in support of the fight against financial crime is being recognized by the IMF and others and is likely to result in additional initiatives.

31. In the Pacific island countries, the issues of money laundering and other illicit financial activities was first addressed in the context of the so-called "Roadshow," on *International and Regional Dimensions of Financial Crime and Risks for South Pacific Forum Island Countries* which was organized by the New Zealand Ministry of Foreign Affairs and Trade and the Reserve Bank of New Zealand and included a number of international experts on these issues. During 1998, the "Roadshow" visited some 13 countries in the region and its presentations and published findings substantially increased the awareness of leaders in PICs about the nature and dangers of financial crimes.

32. Following this and other regional initiatives on the dangers of financial crimes to domestic financial stability and international reputation, a number of Pacific island countries undertook steps to strengthen their regulatory environment for financial institutions and transactions. Additional urgency for taking both domestic and regional action resulted from the inclusion, mentioned earlier, of some PICs in the list of "non-cooperative countries and territories" of the Financial Action Task Force. In response, anti-money laundering laws were introduced in a number of PICs.¹⁷

¹⁵ The discussion of the Board was based on a staff paper entitled *Financial System Abuse, Financial Crime and Money Laundering* which presented a comprehensive assessment of the issues (see <http://www.imf.org/external/np/ml/2001/eng/021201.htm> as well as <http://www.imf.org/external/np/sec/pn/2001/pn0141.htm>).

¹⁶ The IMF has, however, agreed to assist a number of PICs with the establishment of *Financial Intelligence Units* (FIUs) and may assist with legal advice on the creation of a regional FIU for PICs.

¹⁷ By November 2001, Cook Islands, Federated States of Micronesia, Fiji, Nauru, Palau, Samoa, and Vanuatu had established anti-money laundering laws. However, legislation in Nauru was considered inadequate by the FATF. Moreover, reflecting their tight resource constraints, effective supervisory capacity is still lacking in most PICs.

33. The critical issue of financial intelligence was taken up at the *Forum Economic Ministers Meeting* 1999 in Apia, Samoa. At that time, Ministers called for the preparation of a feasibility study into the establishment of a mechanism for financial intelligence information sharing among Forum members. This study is currently under way and will be presented to PICs and their development partners for decision as soon as completed. However, already it is clear that most PICs belong to the group of "host" countries, for which information sharing is peripheral, while success in the fight against financial crimes will depend primarily on the establishment of close cooperation and information sharing arrangements between "home" and "host" countries. Efforts would therefore have to be undertaken by the PICs to reach agreements with the principal "home" countries of operators active in PICs. Where this is not possible on an individual basis, consideration could be given to seek assistance in information gathering and sharing from those large partners in the region (and elsewhere) that have established their own information bases and are in close contact with similar institutions around the world. Ideally, such arrangements would be concluded on a regional basis for the PICs as a group and with the assistance of the principal international bodies involved in this area.

VI. CONCLUDING OBSERVATIONS

34. The rapid integration of financial markets and development of new financial instruments present a considerable challenge to the Pacific island countries and the region as a whole. In particular, concerns about the soundness and stability of financial institutions and markets are growing and have resulted in an increased need for effective financial sector regulation and supervision. In addition, growing evidence of tax fraud and evasion and financial crime such as money laundering has alarmed country authorities and international financial institutions alike and spawned a flurry of activities to control these practices. All of these initiatives will have profound implications for PICs and the way in which financial sector policies and regulation will have to be designed and implemented in the region.

35. The Pacific island countries should generally welcome these developments because they will strengthen the stability of the international financial system and financial sectors around the world and reduce the risks of financial transactions within and between individual countries, including those in the Pacific region. They will also reduce the likelihood that PICs will fall prey to financial crime or suffer a loss of credibility and reputation as a result of shady operators working on their territory or using their name.

36. If PICs are to take full advantage of the potential benefits of recent developments in financial sector regulation and supervision, they will need to be prepared for reforms in their own legislative and regulatory environment and supervision and law enforcement practices. Given their severe financial and human resource constraints, this will not be easy for many of them on their own. It will therefore be necessary to explore and fully exploit the scope for cooperation and coordination among themselves and with third countries. In particular, PICs need to seek regional solutions where individual country efforts would not suffice or be sub-optimal. The recently established **Pacific Islands Prudential Regulation and Supervision Initiative (PIPRSI)** constitutes a promising start in this respect but needs to be made

operational with the introduction of practical steps that strengthen local capacity and exploit economies of scale. In addition, concerted regional efforts should be undertaken by the PICs to strengthen cooperation with third countries because the nature of the challenges posed by internationalization requires an increasing dialogue, flow of information, and sharing of experiences and expertise between “home” and “host” countries. For their part, “home” countries and international organizations will have to recognize the tight resource constraints in PICs and devise solution for them that are sustainable and strike an equitable balance in burden sharing.

PACIFIC ISLANDS PRUDENTIAL REGULATION AND SUPERVISION INITIATIVE

DECLARATION ON COOPERATION

1. The undersigned parties agree that the establishment, adoption and implementation of sound principles and practices for financial stability is a key requirement for steady and sustainable economic development.
2. The undersigned parties concur that the establishment and maintenance of sound financial sectors and institutions is a regional concern. In addition, they recognize the existence of externalities of stable financial sectors, as well as the scope for economies of scale in joint action. They therefore express their intention to strengthen cooperation and coordination in financial sector regulation and supervision between Pacific island countries (PICs). To that effect, they have decided to establish the *Pacific Islands Prudential Regulation and Supervision Initiative* (PIPRSI).
3. The immediate objective of the *Initiative* is to establish a process of consultation and cooperation in regulatory and supervisory matters in the region. Later objectives within this process could be the exchange of information on prudential aspects of financial sector operations; a joint assessment of the strengths and weaknesses of existing prudential regulation and supervision, and the related design of remedial action; the joint move to internationally accepted norms such as the "Core Principles for Effective Banking Supervision" of the *Basle Committee* and other "best practice" guidelines for financial sector soundness and stability. Once sufficient progress has been made in these areas, the desirability and practicality of an eventual harmonization of financial sector regulation and supervision, as well as supervisory reporting, public disclosure requirements, and prudential regulation enforcement practices could be considered.
4. In the interest of strengthening confidence and stability in financial sectors region wide and reducing the risk of contagion, the undersigned parties invite all Pacific island countries not signatories to the present Declaration to join the *Initiative*.
5. The undersigned parties appreciate and acknowledge the assistance in supervisory matters provided so far by the Reserve Banks and supervisory authorities of Australia and New Zealand, as well as the *Pacific Financial Technical Assistance Centre* in Suva, Fiji and its Executing Agency, the *International Monetary Fund*. They call on these institutions, as well as on other competent international organizations such as the *World Bank* and the *Bank for International Settlements* to assist them in the implementation of their *Initiative* with advice, analyses, training and information.

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