Central Banking Act
Independent Advisory Group (IAG)

Phase II Issues Paper
10th August 2022

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Independent Advisory Group and Secretariat

The Independent Advisory Group (IAG) on the Central Banking Act was established by the Treasurer on 13 May 2020. It is chaired by Mr Robert Igara, Chancellor of UPNG and former Chief Secretary to the Government of Papua New Guinea, and Sir Wilson Kamit, former Governor of the Central Bank from 1999 to 2009, both of whom were present and participated in the formulation and implementation of the Central Banking and financial sector regulatory reforms of 2000. The third member of the IAG is Dr Stephen Howes, Professor of Economics and Director of the Development Policy Centre, Crawford School of the Australian National University (ANU), who has undertaken significant economic policy advisory roles and research in PNG including through the Australian National University and University of Papua New Guinea partnership program

The IAG is also supported and works closely with the Department of Treasury and the Bank of Papua New Guinea, including through the Joint Technical Group and secretariat.

The IAG Technical Group/Secretariat includes: from the Department of Treasury, Ms Wendy Tom-Isu as Executive Manager, Mr Sioni Ioa and Mr Ephraim Danny, Assistant Secretaries for General Economic Policy and Fiscal & Monetary Policy Branches, respectively; from the Bank of Papua New Guinea, Mr Jeffrey Yabom and Ms Sabina Deklin, Managers Research and Banking Supervision Departments, respectively, and Mr Eli Direye, Senior Research Officer; and from the ANU Development Policy Centre, Ms Alyssa Leng, Research Officer. The IAG and Secretariat are supported by an adviser Mr Carel Oosthuizen who is an international financial and banking expert, former Deputy Head of the South African Banking Regulatory and Supervisory Authority, and who has worked in PNG before. The IAG and Secretariat are also supported by Mrs Grethel Mogi as Executive Assistant.

1. Introduction

The Independent Advisory Group (IAG) presented to the Treasurer in November 2021 its Report on the Phase I of the Review of the Central Banking Act 2000. The Phase I Report covered governance, accountability and transparency; government financing; crisis management and the review of the Bank's objectives. The report included thirty-one recommendations which were brought to the attention of the National Executive Council (NEC). The Review resulted in the passage of the Central Banking (Amendment) Act 2021 which saw –

- Balance in objectives of the Central Bank, in particular: formulating and implementing monetary policy with a view not only to achieving and maintaining price stability, but also to promote employment and economic growth, especially of the non-mineral and non-petroleum sector; development of the financial system in Papua New Guinea; and providing an efficient and responsive banking services to the Government.
- A strengthened role of the Board of the Central Bank, especially over monetary policy and financial sector regulation.
- Strengthened independence and transparency of the Central Bank and improved communication with Government.
- The introduction of limits on advances to the Government, with temporary increases allowed in periods of national emergency.

With the completion of the IAG's Phase I work and the decision of the NEC, the Minister for Treasury approved on 7 April 2022 the Terms of Reference for Phase II of the IAG's mandate. The NEC approved that the Phase II review cover broader issues of regulation of the financial system, actions to encourage competition, and follow on work of the Financial Sector Reform Review (FSSR) that was undertaken in 2015.

The Phase II TOR outlines three main areas of work for the IAG in its second phase. The first involves dealing with outstanding issues under Phase I. The second involves new Phase II issues. The third involves consultation and dialogue. This issues paper deals with the first and second points above. It will promote consultation and dialogue through an invitation to make submissions to the IAG in response to this Issues Paper.

Since the main focus of the IAG in its second phase is the financial sector, we begin with it, and then turn to Phase I outstanding issues.

2. Financial sector and related issues

This main part of the TOR can be divided into eight issues.[1]

a) Competition and regulation in the banking and financial sector
b) Impact of new technologies on the financial sector
c) The reduction of interest rates on government debt.
d) Crisis and lender-of-last resort provisions[2]
e) Financial sector regulatory arrangements
f) Review of Anti Money Laundering and Counter Terrorism Financing Act governance and impact on the informal economy.
g) Cash shortages
h) Other issues as required

Each of these eight items is considered separately below. Where possible, we draw on existing work, and avoid reinventing the wheel. We will conduct our own analysis only when it is needed to fill a gap. We also note that there is a large backlog of recommendations already agreed to by the government which have not yet been implemented. There is little point generating a long list of additional reforms if the existing ones are not acted on. We therefore aim to come up with a prioritized list of reforms, and to indicate which ones are the most urgent.

In terms of analysis already completed and recommendations already accepted, the following reports are of particular interest and value:

- 2021 Discussion Paper on Superannuation and Life Insurance Review (SLIR)
- 2018 World Bank Financial Consumer Protection Diagnostic report
- 2018 Financial Sector Development Strategy 2018-2030
- 2015 Financial Sector Regulatory Architecture (FSSR (Financial Sector Services Review) Diagnostic Report)
- 2015 PNG Government Bond and Capital Market Development (FSSR Diagnostic Report)
- 2015 Financial Inclusion in Papua New Guinea (FSSR Diagnostic Report)
- 2011 IMF Financial Sector Assessment
- 2007 ICCC review of the insurance sector

[1] There are six issues under section (b) of the TOR. The first is divided into two, which takes the number up to seven. The issue of lender-of-last-resort is moved from Phase I outstanding to Phase II to take the total up to eight. The ordering of issues is for convenience slightly different to that given in the TOR.
[2] This is presented as a Phase I outstanding issue, but is better considered under Phase II.

a) Competition and regulation in the banking and financial sector

Overview

Issues facing PNG's financial sector include excess liquidity (more deposits than loans), high interest rates, and the difficulty small and medium enterprises face accessing credit. Reports on PNG's financial sector typically note the lack of competition in the financial sector, especially in banking. However, there is a lack of recommendations as to how to remedy this. More competition should drive down rates, and increase the volume of loans and customer base, and should therefore be a major focus of this review.

BPNG is responsible for the regulation of all financial institutions, except general insurance (regulated by the PNG Insurance Commission) and the stock exchange (regulated by the PNG Securities Commission). Promoting competition in the banking sector is therefore a matter for BPNG, under the Banks and Financial Institutions Act 2000 and the Savings and Loan Societies Act 2015.

While both banks and licensed financial institutions are authorised to carry on banking business, banks can accept money on deposit that is repayable on demand while licensed financial institutions (LFIs) are authorised to offer term deposits (World Bank 2018 Financial Consumer Protection Diagnostic report). Savings & loan societies are permitted to accept deposits and disburse loans only to their members.

A good overview of the PNG financial sector is provided in the 2015 FSSR Report. The BPNG website also contains useful information. There are currently four banks (BSP, Kina, ANZ and Westpac), 9 licensed financial institutions, 4 microbanks, and 16 savings and loan societies. The commercial banks have assets of K32.6 billion, finance companies K1.3 billion, S&L societies K1.6 billion, and microfinance companies K300 million.

Banking

There are several factors that work against greater competition among PNG's banks and its financial sector more generally. One is the global trend of derisking, which means international banks are more risk-averse, and so less interested in operating in what are perceived to be high-risk countries like PNG, and also less interested in establishing correspondent relations with PNG banks. The cost of operations is also high in PNG, and many towns are only big enough to support one branch (at best).

Some finance companies are interested in upgrading to banking status. TISA Community Finance Limited applied for a banking license in November 2020. Credit Corp has indicated that it will apply for a banking license in the course of the year. Heduru Moni Limited (Moni Plus) and People's Micro Bank Limited have also announced plans to apply for Commercial Banking Licenses.

A better understanding is needed of why more banking licenses have not been granted. In the past, BPNG's only mandate with regard to the financial sector was to ensure stability. This might have made it extremely reluctant to allow new entrants, as was with new entrants always comes new risk. However, following last year's amendments to the Central Banking Act, BPNG is now mandated to promote financial sector development as well as stability. This could be expected to change BPNG's outlook with respect to new license applications. (Under the Banks and Financial Institutions Act 2000, BPNG is "to promote the general stability and effective working of the financial system in Papua New Guinea" (Section 5(1)).

Some financial sector regulatory authorities develop competition strategies for increasing banking sector competition. For example, the Bank of England has a financial sector competition objective which it reports against.

Superannuation

Superannuation is another important part of the financial sector, also one with limited competition. A superannuation review is currently underway. The work of the IAG will complement this review by focusing on issues of enhancing competition and regulation.

Insurance

General and life insurance form other key aspects of the financial sector, despite relatively low rates of cover in PNG. Competition is again limited and there is a lack of understanding by the general public on the purpose of insurance and how it operates. While life insurance is regulated by BPNG, general insurance falls under the PNG Office of Insurance Commission. The Superannuation and Life Insurance Review Committee are undertaking a review on the life insurance industry to determine appropriate action to address problems in the regulation and operation of this industry. Complementary work on the general insurance industry, including through the IAG, will use findings from the current review as a basis for further discussion. The alignment of standards and effective supervision across the two insurance industries should be a key focus, given the potential for contagion.

SME Financing

Our Phase II TOR calls for, among other matters, recommendations regarding the regulation of banks and other financial institutions, in particular on how to prudently *"…expand the capacity of the domestic financial sector the economy's needs for credit, drive down borrowing costs, and* ***better meet the needs of small and medium enterprises including through open banking and fintech****"*.

The small and medium enterprises (SME) sector is internationally recognised as a significant contributor to GDP growth and employment. The banking and financial system is in turn a major contributor to the growth of the SME sector.

(a) SME Financing Challenges

The ability of SMEs to develop, grow and be sustainable relies heavily on their capacity to access and manage finance. Surveys conducted by the ADB in eight countries including PNG during 2013 and 2015 revealed several supply side barriers. Inadequate collateral and guarantee requirements for loans were the top barriers for micro, small and medium enterprises (MSMEs) to access formal financial services, followed by financial institutions' strict lending policies, complicated procedures to borrow money, and high lending rates.

On the demand side, two problems were prominent: a lack of knowledge of available financial products and services, and MSMEs' insufficient management skills and human resources. In addition, there was a significant proportion with "no demand" for funds from the formal financial institutions suggesting a hesitation to seek financing from banks (Rethinking MSME Finance in Asia and the Pacific: A Post-Crisis Policy Agenda, ESCAP, 2021).

To overcome the constraint of bank lending for SMEs, the diversification of financing modalities is required. National SME finance policies related to access to finance in the Asia Pacific region still focus on enhancing bankability. However, a balanced approach is needed to incentivize banks, capital markets and nonbanking financial institutions to promote SME access to finance.

The extent to which these should be adopted in PNG is an important topic for consideration, bearing in mind the risks of abuse and corruption that might arise.

(b) The 2016 SME Policy

To promote its SME sector, the Government adopted and launched in 2016 a comprehensive **SME Policy and Masterplan 2016-2030** to support SME growth including through policy and institutional reforms, and financing support. The objectives of the policy are to support and grow the SME sector in order to create new employment opportunities, achieve sustainable economic growth outside the resources sector, and achieve a fair and equitable distribution of wealth through majority citizen ownership of business activity.

Some of the 15 key strategies proposed are:

- Develop appropriate policy and legislative framework to support the SME sector
- Develop a holistic financial inclusive and access framework that will facilitate the growth of SMEs
- The Government to facilitate adequate government funding and resourcing support to grow then SME sector.

In support of these strategies, the SME Policy also proposed several specific initiatives which include:

- Government to intervene either directly or indirectly in the banking and financial services sector to ensure appropriate credit finance is readily available and easily accessible by SMEs throughout their life cycle.
- Review of all bank fees.
- Government to continue to cap National Development Bank (NDB) interest rates at 6.5% with NDB capitalized with an additional K 1 billion by 2012 and the People's Micro Bank (PMB) funded with K 20 million annually. NDB and PMB to become a fully commercial bank and rebranded as SME Bank by Q1/2017.
- Creation of a Credit Guarantee Corporation (similar to the Malaysian model) during 2017 with Bank of PNG and private funding.

- Development and implementation of tax rules and incentives specific to SMEs, with specific proposals for a 5 year start up tax holiday for micro and small businesses, reduced tax rate for SMEs and tax credits for large companies who provide patronship, mentoring or business development services to grow SMEs.
- Reservation of various sectors for national businesses, and requirements that businesses below a certain size exclude or limit foreign ownership.

The government has implemented some but not all of these measures. The appropriateness of various of the measures will require careful analysis, with consideration also needing to be given to the need to attract foreign investment and the risks of "government failure".

(c) Definition of SMEs

There is no harmonised SME definition in Asia and the Pacific. The definition commonly includes classification by employment, assets or capital, and revenue (sales turnover). The two criteria – employment and assets or capital and revenue – have been used by several economies.

The 2016 PNG SME Policy provides the following definition by sector, sales turnover, number of employees and asset value.

	MICRO	SMALL	MEDIUM
Annual Sales Turnover	<K 200,000	>K 200,000 & <K 5 M	>K 5 M & < K 10 M
Employees (MCE)	< 5	>5 & < 20	>20 & < 100
Employees (ATFFO)	<5	>5 & < 40	> 40 & <100
Total Assets	< K 200,000	>K200,000 & <K5 M	> K 5 M & < K 10 M

Note: MCE - Manufacturing, Construction & Engineering
ATFFO - Agriculture, Tourism, Forestry, Fisheries and Others

The Bank of PNG through the National Financial Inclusion policy and strategies does recognise the important role of Micro and SME sector, acknowledges the Government's 2016 SME Policy and Masterplan, and the need to enhance SME access and usage of finance, but has not itself and the has not published its definition of an MSME.

The Central Bank of Malaysia has formally adopted the definition endorsed by the Malaysian National SME Development Council since 2005 and the Guidelines on SME Definition issued by the SME Corporation of Malaysia issued in 2014. Broadly, the SME definition is in two categories:

- **Manufacturing:** Sales turnover not exceeding RM 50 Million OR full-time employees not exceeding 200 workers; and
- **Services and Other Sectors**: Sales turnover not exceeding RM 20 Million OR full-time employees not exceeding 75 workers.

BSP and Kina Bank have different definitions whilst Finance Companies do not appear to have a definition.

The adoption of a uniform definition of SMEs provides the basis of data collection and policy analysis. One option would be for the Bank of PNG to consider adoption of a PNG SME definition based on that stated in the 2016 SME Policy and Masterplan and issue appropriate guidelines for banking and the financial sector.

Many SMEs, including microenterprises, get financing through the *wantok* system. Families and communities come together to support a promising enterprise. This is a strength of PNG's traditional system, and it may be one that could be made use of, for example, through group-lending schemes that have been made famous in Bangladesh and now many other countries.

In undertaking its review the IAG will assess the roles of the Bank of PNG, commercial banks, finance companies, microfinance companies, the NDB and other Non-Finance Institutions in the promotion of SME financing and growth. The relevance of international experience in SME finance and growth will be fully assessed including the policies adopted by governments in response to the Covid-19 Pandemic crisis.

Land-owner trust funds

Land-owner trust funds are not subject to BPNG regulation. Unregulated land-owner trust funds hold the potential for a whole gamut of abuses and the consequent destruction of capital. A sound regulatory and supervisory framework could benefit current and future generations substantially.

Payday lending and other personal lending

While there are, as noted above, only 13 LFIs registered with BPNG as per its website, there are many more finance institutions. A study of public sector payday lending shows that there are 131 finance companies who receive repayments from public servants. (This is for the central payroll and does not include teachers, soldiers, police and other agencies on separate payroll systems.) Only financial institutions that receive deposits are required to be licensed by BPNG under the Banks and Financial Institutions Act and Savings and Loan Societies Act. However, a broader range of entities are required to be registered under the Anti Money Laundering and Counter Terrorism Financing Act. Whether non-deposit-receiving financial institutions should be subject to BPNG regulation requires further investigation.

More broadly, the extent of payday lending is itself a concern. The same survey of the central payroll mentioned above found that in Pay 25/2021 over K12.5 million was deducted in repayments fortnightly (about 7% of the relevant payroll) for more than 44,000 public servants from a total of 67,000 (again this is apart from Teachers, Defence and Police as well as others on separate payroll system). Concerns raised in the past about the impact of these repayments on the discretionary income of officers had led to an executive decision to cap such repayments at 50 per cent. Interest rates are unregulated and often extortionary. There is very little by way of education, and public servants (and other workers) may find themselves trapped in a cycle of loans and repayment. Since the government is facilitating payday lending by allowing salary deductions it also has a duty to ensure that employees are not harmed by the practice. The government could also consider legislation to regulate payday and other forms of personal lending, as some countries have done such as South Africa through its *National Credit Act*.

Another unregulated practice is that of Digicel PNG Limited, which allows customers to go into debt to buy phone credits. The expected rate of return for Digicel on this practice is estimated by analysts to be 17% per week. This practice is separate to the Cell Moni product operated by Digicel Financial Services as a payment service provider.
Certainly, the business of personal loans more broadly seems to be growing rapidly. Heduru Moni Limited trading as Moni Plus recently announced growth in its lending account (personal loans) of 65.5 per cent or a total of K406.1 million as at December 2021. It also announced a net profit after tax of K106.9 million for 2021, a growth of 24.6 per cent over the 2020 results.

Consumer credit is an advanced financial product requiring sophisticated understanding of complexities of legal agreements and interest rate computations (including compounding) to ensure optimal benefits to a consumer. Consumer credit provision takes on a number of guises and is fraught with potential for suboptimal outcomes for consumers as well as abuse of consumers by unscrupulous providers of consumer credit. The suboptimal outcomes are of an enduring nature given that these agreements extend over time. Causes for the suboptimal outcomes for consumers from consumer credit include consumer literacy and numeracy challenges, and consumer ignorance and/or lack of understanding. Other causes include credit providers who have a reckless disregard for clear negative implications of their offerings for a consumer, credit providers who engage in misrepresentation and even fraud while plunging a consumer into over-indebtedness, household and social upheaval and even financial ruin. This is a specialized and complex area requiring a focused holistic solution.

Consumer protection

The 2018 Diagnostic Review of Financial Consumer Protection (FCP) found that "the FCP legal and regulatory framework is extremely limited" and made a number of recommendations for legal reform (see its Table 1). The same report recommended that BPNG be designated as solely responsible for the FCP legal and regulatory framework, and that the Central Banking Act, the ICCC Act and Insurance Act all be amended accordingly.

In 2019, BPNG consulted on a "Draft Financial Consumer Protection Regulations". A proposed Financial Consumer Protection law, along the lines of the regulation, but with wider scope, has now been drafted and will clarify the role of the BPNG in regards to consumer protection going forward.

PNG's Independent Consumer and Competition Commission has the objective through its Act to "enhance the welfare of the people of Papua New Guinea through the promotion of competition, fair trading and the protection of consumers' interests." The division of labour between the ICCC and BPNG with regards to customer protection needs further review. ICCC certainly has an important role to pay in customer protection and also in financial sector regulation since it has to provide approvals for mergers and acquisitions if they will significantly reduce competition (see section 82 of the ICCC Act). The ICCC recently disallowed Kina's proposed purchase of Westpac. While this seems like an appropriate role, it should also be considered by any review of financial sector regulation and competition.

A financial ombud (sometimes called an ombudsman or ombudsperson) is an independent conflict resolution practitioner who provides confidential and informal assistance. An ombud can be part of a self-regulating industry-driven initiative, such as a banking system ombud, or a statutorily established institution, say an ombud for the financial services who is appointed by the Minister of Treasury. An ombud can play a valuable role in consumer protection by intermediating in complaints between financial services providers and the general public, including customers of such financial services providers.

2a. Questions for analysis:

- Are banking license requirements appropriate?
- Are legal or regulatory changes required to promote banking competition?
- Should BPNG have an obligation to promote competition in the banking sector, and to develop strategies for the same, and report against them?
- Are financial institutions operating without a license/registration operating legally and should licensing requirements be broadened?
- How can competition and regulation in the superannuation and insurance sectors be enhanced?
- Should land owner trust funds be regulated?
- Is the growth in payday lending a concern, and does there need to be tighter regulation and/or a better education campaign?
- Should the Financial Consumer Protection framework be strengthened, and if so, how?
- What should be the role of ICCC and BPNG?
- Should existing credit guarantees and other funding support be extended or reformed?
- What other measures should be taken to promote lending to micro, small and medium enterprises?
- Would the introduction of a financial ombud be useful as an instrument to promote consumer protection and, if so, what parameters should apply to such an office?

b) Impact of new technologies

The PNG 100 CEO Survey conducted in 2019 found that unreliable telecommunication was the major constraint on business, but it has receded as a concern in more recent years. According to the Datareportal (in its Report on Digital 2021: PNG), there were 1.37 million internet users in PNG by January 2021 (15.2% internet penetration) from a total population of over 9 million, 13.4% who reside in the urban centres while 86.6% live in rural areas. The number of internet users in PNG increased by 270, 000 (over 25%) between 2020 and 2021. Mobile coverage now extends to many rural and remote areas of PNG.

Electronic and phone banking particularly in the rural and remote areas have become popular as a result of greater internet access, which has helped reduce travel times and the risk of theft in handling cash. The IAG would welcome information from banks and other financial sector players regarding their use and planned use of digital technology to extend banking access and services.

Financial services are also accessible through mobile networks in addition to online banking. Digicel Financial Services Limited is currently the only mobile network operator with a license from BPNG, provided through BPNG's Oversight Directive issued in 2019 under the National Payments System Act 2013. As such, it is "authorized to collect and transfer money through the use of mobile phones". Its Cell Moni product offers limited financial services including money transfers, bill payments and phone credit purchases by registering their phone number to an electronic wallet, with a maximum balance of K2000-5000 as mandated by BPNG. While anecdotal evidence suggests that it has so far seen limited take up, as preferences seem to be stronger for online banking services provided by other banks and financial institutions, the potential for expanding this model to other mobile network operators or linking it to other electronic banking technology merits further discussion. The adequacy of the Oversight Directive issued by BPNG in 2019 under the National Payments System Act 2013 should also be considered.

The functioning of new payment technologies should also be examined more closely. The Kina Automated Transfer System (KATS) was developed by BPNG in collaboration with the private sector to minimize financial transaction processing times. It has been successful in reducing payment times by allowing for electronic transfers, and more efficient cheque clearing via imaging. Yet long delays in payment of government cheques to service providers are nevertheless reported. An Electronic Funds Transfer (EFT) service has been in place for government payments since 2016, but is not widely used because it is limited to government-to-government agencies (especially statutory bodies, and sub-national agencies). Therefore, private contractors and service providers are paid through cheques. The approach going forward is to process all payments through EFT. The Government has already started the process since 2021 by centralizing the payments for utilities and rentals through the Department of Finance where payments are made through EFT. Another barrier is non-compliance with Finance Department regulations regarding processes and documentation. If this is the basis for payments being held up, then it is unclear that shifting to an electronic system will help. But should this be the responsibility of the central bank or is this a case of over-reach?

How challenges associated with new technologies are managed also warrants a closer look. Cyber-crime activities including phishing emails, internet fraud, account hacking, viruses and malwares pose serious risks to the day-to-day functioning of the financial system. The 2021 malware attack on the Department of Finance's Integrated Finance & Accounting System (IFMS) halting all government financial transactions for months is a classic example. Other risks and constraints arise from access to electricity, high cost of internet and slow data speed.

Cybersecurity risk is a universal risk which can inflict painful, debilitating, disastrous and even fatal outcomes on its victims. Cyberattacks are increasingly sophisticated, unobtrusive, and frequent. The International Organization of Securities Commissions (IOSCO) (2016) has "recognized that cyber risk constitutes a growing and significant threat to the integrity, efficiency and soundness of financial markets worldwide." In fact, it is a risk for any person or organization interacting with and/or making use of any modern electronic device containing a microchip – a trend which is inexorable. Authorities at the highest levels should take the lead in developing frameworks, strategies and action plans aimed at protecting the common good from this risk and providing guidance to the general population regarding sound practices.

The rise of cryptocurrencies (i.e., virtual currencies or digital money such as bitcoin and etherieum) is another area of concern. The BPNG put out a public notice in 2021 to warn the public against the use of cryptocurrencies as currencies that are not issued or regulated by the Bank as they are considered "high risk and speculative". The Bank, however, has been "researching into the potential use of blockchain technology as a platform for promoting financial inclusion in PNG". Cryptocurrencies and related assets have also been under review by FASU (located within BPNG) from the perspective of the AML/CTF Act. That review has pointed to the difficulty of ensuring AML/CTF compliance in relation to virtual assets. The need for further action by FASU or BPNG more broadly requires further action.

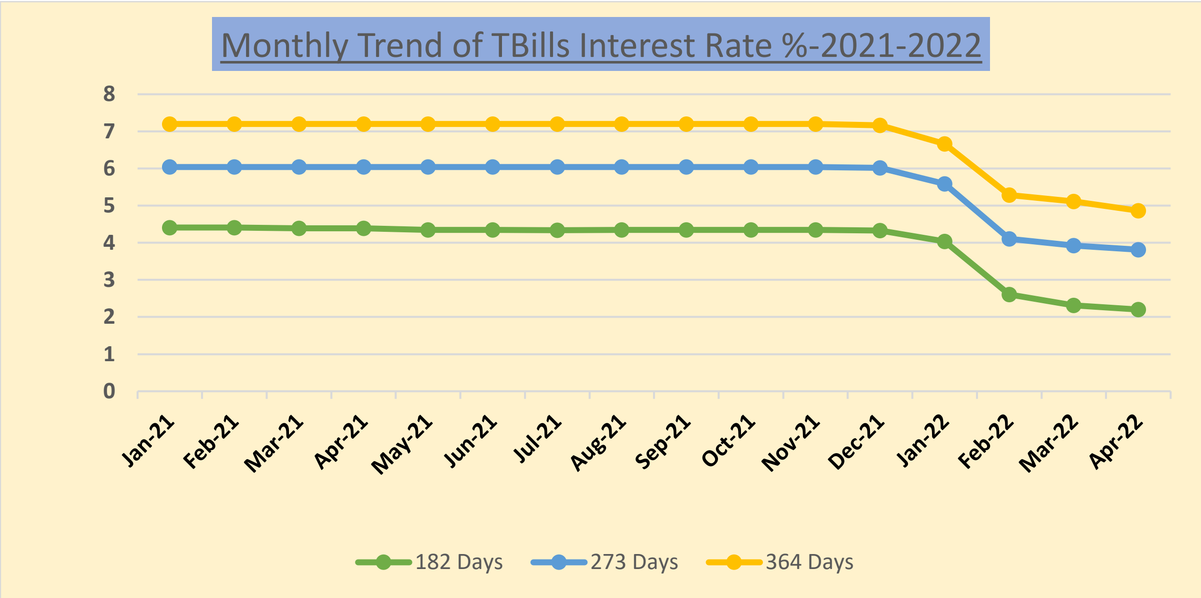
2b. Questions for analysis:

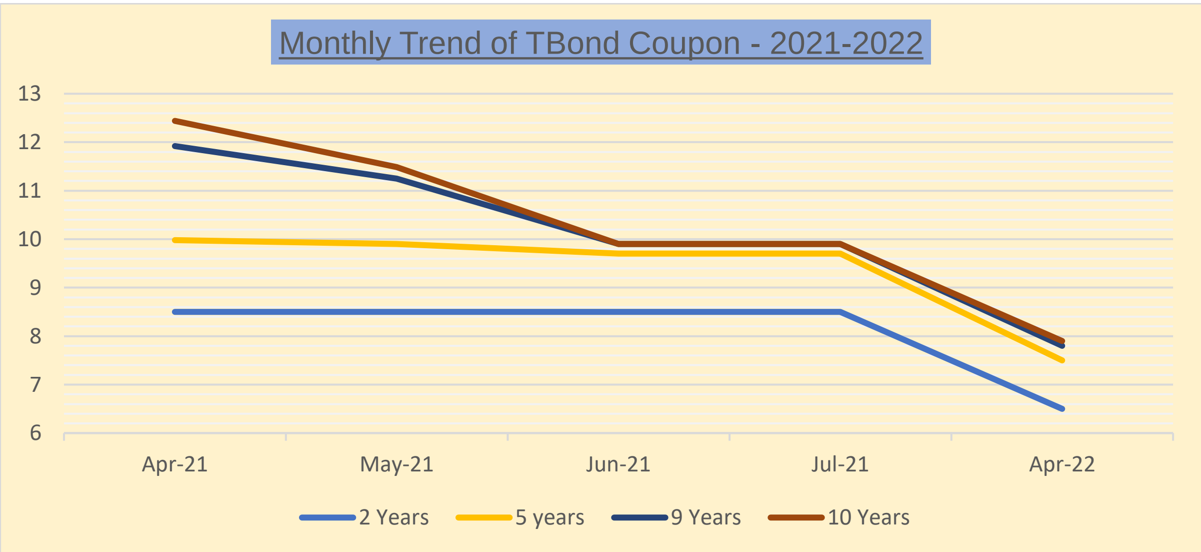
- Can more be done to increase mobile and online banking, with licenses given to other operators?
- Are any legislative or regulatory changes required?
- What is the nature of a mobile network operator or banking license (including any consumer protection measures), are changes needed to it, and can other mobile operators access such a license?
- How can more efficient payment arrangements be put in place, especially for government payments?
- Are any changes needed in the regulation of cryptocurrencies and related instruments?
- How should PNG best approach and manage the issue of cybersecurity?

c) Increasing competition in domestic government debt markets

Our Phase I report drew attention to the problems in the government domestic debt market and to high interest rates, indicative of limited competition.

Despite this, good progress has been made over the last two years in reducing the cost of government debt, thereby freeing up funds for basic services. The average rate on T-bills has fallen from 4-7% to 2-5% over 2022. The average rate on Treasury bonds has fallen from 8-13% in 2021 to 6-8% this year. This may reflect depressed economic conditions. However, it also reflects a more aggressive stance by Treasury in setting rates. Given that, as discussed in the first phase report, deposit rates are so low and there is excess liquidity, there is scope for Treasury to drive rates down by taking a tougher stance. (Banks and superannuation funds have limited alternative options.) As long as excess liquidity remains and deposit rates are low, there should be scope for a further reduction in rates.





The TAP Facility which is aimed at small investors is a worthwhile initiative, but too small to have a major impact in terms of increasing demand for bonds and reducing interest rates. Rules around participation of domestic investors in government security auctions should be reviewed.

The 2015 FSSR report on government debt indicated that a stated goal of Treasury and BPNG is to attract a non-resident investor base into the PNG local market (p. 39). However, nothing has been done to progress this.[3] According to the World Bank, it would require: updating and automating the primary market auction system; undertaking public relations; clearly disseminating information; and automating the clearing and settlement system and central depository. It would also require assuring non-resident investors that they could convert their Kina returns into dollars. Licensing arrangements for non-resident investors would also need to be put in place – such investors would need to register and are required to have an onshore bank account for transactions to be facilitated in kina.

A new Central Securities Depository (CSD) auction system for government securities is in place. The CSD system is being developed to replace the Bank's Registry Money System (RMS) to capture the trading and custody of securities in PNG's domestic market. The overall objective of the CSD is to automate the system for efficient market access, penetration, safety and inclusion of wider market participants. The first phase of the project which includes auctioning, settlement and custody of securities, "over the counter" trading, term repurchase agreements, intraday liquidity facility and interbank borrowing and lending for banks was completed in September 2021. Phase 2 commenced in January 2022 and involves the development of capacities to support secondary market trading and access to the CSD system through a portal. The CSD project is expected to be completed by end of 2022.

2c. Questions for analysis:

- What are the legal and regulatory barriers to non-domestic investors buying government bonds? How can they best and most quickly be addressed?
- How can the reduction in government domestic borrowing costs observed in recent months and years be sustained?
- What improvements can be made to the primary debt market?
- Is the establishment of a secondary debt market a realistic goal, and if so what steps should be taken?

[3] For example, a 2008 proposal from the Asian Development Bank to provide a Kina denominated loan to PNG never transpired.

d) Crisis and lender-of-last-resort provisions

The recent Global Financial Crisis with its concomitant financial instability was the spur for an almost universal awakening to the critical importance of the financial stability objective.

Section 7 of the Central Banking Act 2000, titled 'Objectives of the Central Bank', provides that the BPNG must "(b) … formulate financial regulation and prudential standards to ensure stability and development of the financial system in Papua New Guinea."

The 2015 FSSR report found that no formal arrangements exist around financial sector contingency planning, crisis simulation exercises and a crisis management framework. BPNG is the lender of last resort (LOLR) as the central bank and provides a lending facility for banks that are solvent but face critical liquidity issues. But as it has yet to directly use this facility, little detail exists around how it would potentially operate.[4] There is no deposit insurance, though there is a Cash Reserve Requirement.

The 2015 FSSR report made a number of other recommendations in this area, including:

- Undertake urgently contingency planning and crisis simulation exercises (ST)
- Introduce promptly a standardised repurchase agreement and stimulate interbank market (ST)
- Establish/review the standing LOLR facility (MT)
- Develop internal procedures for bank emergency liquidity arrangements (MT)
- Review and update bank recovery and resolution framework (MT)
- Develop a depositor protection framework and establish a formal deposit insurance scheme (LT)

The extent to which these changes require legal reform needs to be determined, as does the absolute and relative priority of the various items given the small number of banks, especially domestic ones, their high profitability, and the other areas where reform is needed.

PNG would benefit from a holistic, integrated and structured framework for and approach to financial stability as it would enable a graduated approach that is properly prioritised. It can then be rolled out in a measured, methodical and coordinated way while developing the necessary capacity and acquiring the required resources. The overarching regulatory objective of (macro and micro) financial stability will benefit from legislative, regulatory and supervisory frameworks and day-to-day supervision which are effective and aligned with international standards and sound practices. Risk management and a risk-based approach to regulation and supervision are indispensable to successful financial sector regulation and supervision.

2d. Questions for analysis:

- Should BPNG implement deposit insurance and/or other measures to protect the stability of the banking sector at times of crisis?
- Which other FSSR reforms should be a priority?

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[4] The only bank to be in trouble in PNG was PNGBC in the 1990s, which was dealt with by sale to BSP. See Avel 2014 "Comparison of problem bank identification, intervention and resolution in PNG"

e) Financial sector regulatory arrangements

BPNG is PNG's main financial sector regulator, with responsibility for all aspects of the financial sector except general insurance, which is regulated by the PNG Insurance Commission constituted by the Insurance Act 1995, and the stock exchange, which is regulated by the PNG Securities Commission (established by Securities Act 1997, which was updated by the Securities Commission Act 2015 and the Capital Markets Act 2015). With the 2020 CBA amendments, responsibility for financial sector regulation within BPNG has recently shifted from the Governor to the Board.

The 2015 FSSR report on financial sector regulatory architecture recommends that these three bodies (BPNG, the Insurance Commission and the Securities Commission) be merged and that the job of regulating the financial sector given solely to BPNG. It recommends integrating insurance regulation and supervision within BPNG, followed by moving the regulation, licensing and supervision of securities into BPNG. Under this model, financial sector regulatory responsibilities would eventually be transferred into an independent subsidiary of BPNG, ultimately perhaps forming an integrated financial sector regulation and supervision authority.

As noted in the 2015 FSSR report, a key example where such regulatory responsibilities are housed within the central bank is the Monetary Authority of Singapore (MAS). MAS is the integrated regulator and supervisor of financial institutions in Singapore, in which separate internal departments are responsible for supervision and development; there is no subsidiary authority within MAS. Arrangements are similar in Malaysia, where separate departments within Bank Negara Malaysia (BNM) hold responsibility for the supervision and regulation of banking and insurance. A separate external securities commission is responsible for regulating and developing capital markets in Malaysia, with some overlap with BNM in specific areas.

The 2018-2030 Financial Sector Development Strategy (FSDS) agreed that BPNG should take over the role of the PNG Insurance Commission, but also stated that the Securities Commission role as an independent securities market regulator should be strengthened, that it take over the supervision of land-owner trust funds, and that it report to the Minister of Treasury. The strategy left open the question of further integration. This agenda has not however been progressed. The FSDS also proposed that a PNG Financial Services Council (FSC) be established to ensure effective implementation of the Financial Sector Development Strategy.

2e. Questions for analysis:

- What legislative amendments are needed to integrate the Insurance Commission into BPNG?
- Given the lack of progress on the financial sector reform agenda, should the Securities Commission also be absorbed by BPNG?
- Should BPNG also take on responsibility for financial consumer protection?
- What legislative amendments are required to effect these changes?

f) Review of Anti-Money Laundering & Counter Terrorist Financing Strategy

The PNG Anti-Money Laundering & Counter Terrorist Financing (AML/CTF) Strategy was endorsed by the National Coordinating Committee (NCC) and the National Executive Council (NEC) in 2014. This strategy was intended to cover the period of significant reform undertaken by PNG during its engagement and 'grey-listing' by Financial Action Task Force (FATF) over the period 2014-2017.

Following that, the NCC developed the PNG's "National Anti-Money Laundering and Counter Terrorist Financing Strategic Plan 2017-2022". This strategic plan outlines the vision for a strengthened AML/CTF system and it fulfil the requirements of PNG's AML/CTF mandate enshrined in the Anti-Money Laundering and Counter Terrorist Financing Act 2015.

The PNG's AML/CFT strategic, policy-making and administrative arrangements are through the National Coordination Committee (NCC). The Bank of PNG's Financial Analysis and Supervision Unit (FASU) was established in February 2016, and is the responsible Unit through its mandate in the AML/CTF Act 2015. Its establishment gives rise to its national and international obligations to ensure a safer and stable financial system. FASU is now the PNG's Financial Intelligence Unit replacing the previous intelligent unit established at the Royal Papua New Guinea Constabulary (RPNG) under the Proceeds of Crime Act 2005.

The PNG's AML/CFT coordination currently relies on a Memorandum of Understanding (MoU) system. The main purpose of the MoU is to implement the AML/CTF Act to facilitate the sharing of information and intelligence between these organisations and allow for greater cooperation in combating money laundering, terrorist financing and other related serious offences.

PNG is also adopting the Financial Action Task Force (FATF) Standards which provides measures that may assist in the investigation and prosecution of corrupt public figures, and facilitate the freezing, confiscation, and repatriation of illicit proceeds. Some progress has been made to meet the FATF standards. Legal reforms, institutional rearrangements and capacity building are some of the key strategic developments perused to ensure that the AML/CTF national framework once fully developed will be able to function with some degree of efficiency.

A recently concluded short term technical assistance report from the European Union highlighted that the legislative improvements in 2015 have been of significant importance for the PNG Government in moving forward in the fight against money laundering. The assessment showed that while the AML/CTF legal framework is adequate, it could benefit from some adjustments – particularly around financial investigations, Proceeds of Crime's recovery and forfeiture of illicit enrichments. Apart from lack of cooperation and coordination between NCC agencies, implementation of existing laws is also lacking and the report recommended the updating of AML/CTF legislation, regulations, guideline and guidance notes.

The report also provided recommendations to strengthen the AML/CTF policy issue including on the application of the AML/CTF requirements to bank, insurance companies, securities firms, lawyers and other nonfinancial businesses and professions covered by the FATF recommendations.

While the focus is on how the AML/CTF system can be made stronger and more effective, and also for PNG to remain off the FATF's grey list (it was removed in 2016, with the next major evaluation in 2023), it also important for the regulator and relevant stakeholders like the NCC to assess and address any unintended consequences of AML/CTF in PNG's context.

It is claimed by some that, with implementation of the AML/CTF legislation, access to banking services especially the deposit of funds is becoming complicated for people in the informal sector of the economy given AML/CTF customer due diligence requirements. Most of these people especially in the rural areas like farmers, fishermen operate their businesses or sell their goods without any proper documentation. It is possible that some of the stringent measures of AML/CTF will pushed out these people of the financial system. It is also possible that AML/CTF compliance responsibilities will act as a barrier to entry for new banks. Finally, at a time when more Papua New Guineans are working abroad and the government under its labour mobility plan is providing opportunities for decent, temporary work overseas, AML/CTF obligations may make it more difficult to transfer remittances, as has happened with other economies.

These claims require further review. For example, are informal sector workers finding it more difficult to access the banking sector? If so, is this because of AML/CTF, or for other reasons, such as that the banks do not find it profitable to serve such customers?

Recent analysis from Dek Sum (2022) on the Devpolicy Blog recommended that:

> CDD procedures should be simplified for activities and sectors that present a low risk in terms of money laundering and terrorism financing. The global AML/CTF watchdog, Financial Action Taskforce, provides some flexibility in the application of its AML/CTF regime, where a country may decide to exempt a specific type of activity from the usual CDD procedures to accommodate financial inclusion.

It also noted that:

> An analysis found that the AML/CTF legislation in many developing countries has excessively stringent CDD requirements that exceed the country's regulatory and enforcement capabilities. A more realistic AML/CTF framework will help domestic financial institutions to better manage compliance expectations and mitigate the risk of losing a correspondent relationship.

Whether PNG is making use of the available flexibility within the AML/CTF legislation is an important question for review, and should guide any considerations of amendments to the AML/CTF legislation.

2f. Questions for analysis:

- Are there unintended consequences of the AML/CTF regime?

- If so, can steps be taken to ensure that it does not reduce access of the informal sector to banking services, increase barriers to competition, and make it harder to send remittances home?
- Is PNG making sufficient use of available flexibility within the AML/CTF regime?

g) Cash shortage

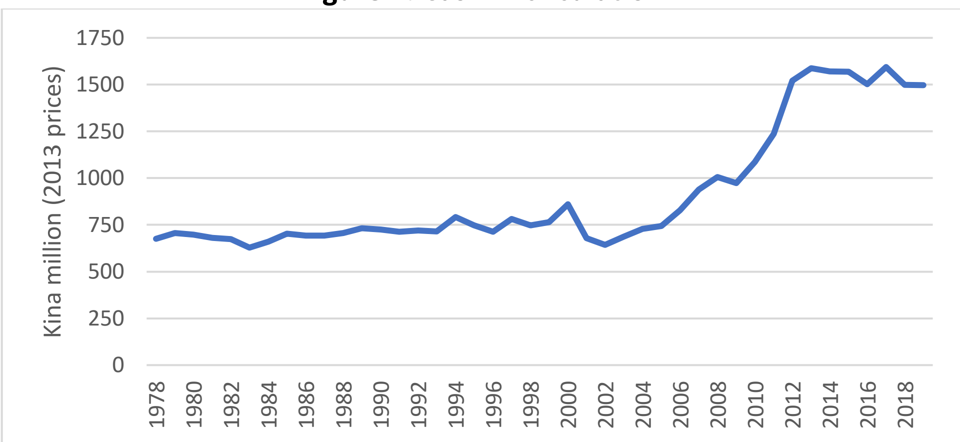
The National on 29 January 2021 ran an article in the Paper citing the Bank South Pacific's CEO assuring its customers that the bank had no plans to shut down the automated teller machines (ATMs) in Port Moresby due to cash shortage. This was a result of a public panic when ATMs around the city were out of cash. The CEO had attributed the disruptions to telecommunication links and the lack of quality bank notes for distribution. The BPNG in response had stated it released new bank notes to commercial banks to fix the shortage of cash.

As per the TOR, and as shown in the graph below, cash in circulation after increasing rapidly during the boom years has been constant after adjusting for inflation since about 2012. On the one hand, consumers and businesses may be making less use of cash. On the other, the lack of real growth in the volume of cash in circulation may be leading to shortages of the sort mentioned above.

One issue is that soiled notes need to be withdrawn, but banks may be reluctant to do this due to the costs involved. This then leads to a lower influx of new notes, and then possibly ATM shortages (since ATMs cannot use soiled notes.)

To the extent that there are any problems, the extent to which there are weaknesses in the legislative framework also needs to be investigated.

Figure 1: Cash in circulation



Source: PNG Economic Database

2g. Questions for analysis:

- How does BPNG discharge its responsibility regarding cash in circulation?
- Is there a cash shortage?
- Are reforms regarding this area of BPNG responsibility required?
- Is the pursuit of a cashless economy reducing demand for GDP?

3. Phase I outstanding issues

The Phase I outstanding issues include the following.

a) The case for a Monetary Policy Committee in light of proposed financial sector regulations.
b) BPNG's finances, and financial relations with government
c) Laws that impact on BPNG other than the Central Banking Act, the main focus of the review.
d) The use of administrative data to get more timely information on the performance of the PNG economy.

Each of these four items is considered below.

a) Revisiting the MPC

The Central Banking Act was amended in 2021 so that by Section 10 the BPNG Board is now responsible for formulation and implementation of monetary policy and financial sector regulation, as well as the issuance of the Policy Statement. The IAG had recommended the establishment of a Monetary Policy Committee (MPC) chaired by the Governor of the Bank which will be responsible for the formulation of monetary policy and oversight of its implementation. The government has not acted on this recommendation pending advice on the governance of financial sector regulation.

Relevant international models for PNG are those where financial supervision is integrated within the central bank. Countries in this category include the United Kingdom, New Zealand, Malaysia and Singapore.

United Kingdom

The financial sector is regulated by the Financial Conduct Authority (an independent body) and the Prudential Regulation Authority under the Bank of England. The PRA is overseen by the Prudential Regulatory Committee (PRC), which is similar to the MPC. Indeed, the Bank of England has three committees: the PRC, the MPC and a Financial Policy Committee (FPC), charged with maintaining financial stability. These are not subcommittees of the Board (Court of Directors) which has overall governance responsibility for the Bank of England, but no specific responsibilities in these substantive areas.

New Zealand

New Zealand has a Monetary Policy Committee, but the Board is responsible for all matters other than monetary policy. The Board has a mandate to regularly review the Bank's performance in promoting the maintenance of a sound and efficient financial system (Reserve Bank of New Zealand Act 1989, section 53(1)(ii)).

Malaysia

The Minister of Finance, on the recommendation of Bank Negara Malaysia (BNM, the Malaysian Central Bank), holds the power to provide licenses for banking, insurance or investment banking businesses (Financial Services Act 2013, section 8). BNM has a Monetary Policy Committee (MPC), an internal financial stability committee (FSC) which considers risks to financial stability and where necessary decides on policy responses, and a Joint Policy Committee comprised of members from both the FSC and MPC.[5] In cases where BNM intends to apply financial stability powers on entities beyond the Bank's regulatory authority, or requires the use of public funds, decisions are taken by the Financial Stability Executive Committee, an inter-agency committee.

Singapore

The Monetary Authority of Singapore (MAS) has a board of directors which is responsible for the policy and general administration of MAS' affairs and business. A committee of the board, known as the Monetary and Investment Policy Meeting, has responsibility for monetary policy. There appears to be no equivalent committee for financial regulation.

3a. Questions for analysis:

- What is the best way to structure governance arrangements within BPNG for monetary policy, financial regulation and financial stability?
- Should BPNG have, in addition to its Board, two empowered committees (an MPC, and an equivalent financial sector regulatory committee), just one (an MPC), or none?
- Should financial regulation and stability be combined or separated?
- If there should be empowered committees (that is, legislatively mandated committees that are not subcommittees of the Board), how should they be structured?

[5] For more detail, see Central Bank of Malaysia 2017, 'Macroprudential frameworks: implementation, and relationship with other policies – Malaysia', BIS Papers No 94.

b) BPNG finances and financial relations with government

The Central Bank has a special role to play in the country. The role of the Central Bank can be compromised if it is pressured to engage into activities that will contradict its independence.

The 2017 National Budget announced a Dividend Policy but it has not been formalized. Distribution of dividends from BPNG is governed by the Central Banking Act. There is rightly provision (as there is in other countries, e.g. India) for the payment of dividends by BPNG to the Government provided that BPNG finances are sound, and such dividends are affordable.

Specifically, the CBA states that net operating profits of the Bank shall be divided between Bank reserves and payments to Government (dividends) based on the determination of "the Minister in consultation with the Board" (Section 49(2)). 9 Section 49(3) is clear that "no amount shall be paid" to Government "where, in the opinion of the Central Bank, the assets of the Central Bank are, or after the payment would be, less than the sum of its liabilities and paid-up capital."

However, as discovered through the Phase One work, dividends were illegally paid by BPNG to Treasury in 2011, 2014 and 2015 (see Chapter 2, Section 2.5 of the Phase One report). A review is needed as to whether the Central Banking Act is in line with international best practice on dividend payment, and whether any amendments to the Act are required to prevent illegal dividend payments in the future.

3b. Questions for analysis:

- Are the conditions for dividend payments in the Central Banking Act clearly defined and in line with international good practice?

c) Other laws impacting BPNG

There are a range of other law that impact on BPNG other than the Central Banking Act. These laws need to be reviewed, and their impact on BPNG identified and reviewed prior to any amendments being proposed. Relevant acts include:

- Anti-Money Laundering and Counter-Terrorism Financing Act 2015
- Audit Act 1989
- Banks and Financial Institutions Act 2000
- Capital Markets Act 2015
- Insurance Act 1995
- Life Insurance Act 2000
- Loans and Securities Act 1960
- National Payments System Act 2013
- National Procurement Act 2018
- Personal Property Security Act 2011
- Public Finances (Management) Act 1995
- Salaries and Conditions Monitoring Act 1988
- Savings and Loans Act 2015
- Securities Commission Act 2015
- Superannuation (General Provisions) Act 2000
- Treasury Bills Act 1974

3c. Questions for analysis:

- Are there features of the Acts listed above (or of other Acts) which impinge on BPNG, and which should be amended to improve central bank governance, accountability, efficiency and independence?

d) Administrative and timely data

Problems around data availability and timeliness for both economic and financial indicators in PNG are well known. One way to improve the current situation would be to use administrative data collected by government departments and businesses to supplement existing information. In particular, information collected by payroll and superannuation companies could augment traditional economic indicators by providing more frequent and up to date estimates of the formal labour force and wages. Taxation data could also be used to supplement existing indicators on an annual basis.

Key agencies like the BPNG and Treasury websites must be updated on a regularly basis as well on information on monetary and fiscal policy.

3d. Questions for analysis:

- What sources of administrative data may be accessible for analysis and public access?
- What areas are currently in most need of more up to date data that could benefit from additional resources?
- What role should different agencies (NSO, BPNG, private sector institutions, research institutions, business organisations) play in this effort?

4. Conclusion

Submissions are welcomed that address any of the questions highlighted in Sections 2a to 2g and 3a to 3d. Those making submissions are also encouraged to raise any other issues of relevance.

The deadline for submissions is August 26, 2022. Submissions should be sent in writing to pngcbaiag@gmail.com.