

Papua New Guinea

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Summary

There are only a small number of microfinance programs in Papua New Guinea, and their performance has, in general, not been strong. Moreover, licensed banks and savings and loan societies have been reducing their coverage in regional and rural areas over a period of decades. While there is a demand for microfinance, and especially for savings facilities, low population densities and high cost structures make it very difficult for institutions to achieve sustainability.

The Bank of Papua New Guinea (BPNG) has undertaken few if any "developmental" activities to support microfinance, but has commenced a program of revitalizing savings and loans societies to increase coverage of financial services in rural areas. It has also licensed an innovative small bank with a mandate to serve the underprivileged.

Recent legislation designed to assure the independence of BPNG may assist it to achieve the macroeconomic stability necessary for sustainable microfinance. There is further scope for the central bank to encourage the development of a more sustainable microfinance sector through low-key "promotional" activities.

Papua New Guinea

Currency Equivalent

Currency Unit – kina (K)
US\$1 = K2.50 (at mid-1999)

Abbreviations

ADB	Asian Development Bank
AusAID	Australian Agency for International Development
BPNG	Bank of Papua New Guinea (the central bank)
DTI	Department of Trade and Industry
ESCAP	Economic and Social Commission for Asia and the Pacific
FINCA	Foundation for International Community Assistance
GDP	gross domestic product
GNP	gross national product
M3*	a Broad Money measure used by the Bank of Papua New Guinea
MFI	microfinance institution
MLAR	minimum liquid assets ratio
NBFI	nonbank financial institution
NGO	nongovernment organization
NZODA	New Zealand Overseas Development Assistance
PNG	Papua New Guinea
PNGBC	Papua New Guinea Banking Corporation
PnK	Putim na Kisim
RDB	Rural Development Bank of Papua New Guinea
ROSCA	rotating savings and credit association
S&L	savings and loans society
SME	small and medium enterprise
UNDP	United Nations Development Programme
UNIFEM	United Nations Development Fund for Women
VFL	Village Finance Ltd

Note

In this report, “\$” refers to US dollars.

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1. Introduction and Background

1.1 Key Demographic and Economic Data

A particularly marked dualism exists in PNG, between a "modern" economic sector and a continuing large subsistence agriculture sector

Papua New Guinea (PNG) had a population of 4.5 million in 1997, after growth averaging 2.2 percent per annum from 1980. The population is relatively sparse, averaging 10 persons per square kilometer on a land surface of 463,000 square kilometers. Gross national product (GNP) per capita was \$930 in 1997, while on a purchasing power parity basis, real gross domestic product (GDP) per capita was \$2,654. Only 17 percent of population was classified as urban in 1997. While value added in agriculture contributed only 28 percent of GDP in 1997, the proportion of the workforce in agriculture remained as high as 79 percent as late as 1990. This illustrates a dualism in the economy, between a high value added mineral export sector on the one hand and a continuing large subsistence agricultural sector on the other. This dichotomy is also seen in the data for distribution of income. In 1996, PNG had a Gini index¹ of 50.9, with the lowest 10 percent of population gaining only 1.7 percent of income and the top 10 percent enjoying 40.5 percent of income.²

In terms of human development, PNG rated a Human Development Index score of 0.570 in 1997, ranked 129th in a list of 174 countries. In 92 developing countries for which the United Nations Development Programme (UNDP) calculated the Human Poverty Index, PNG ranked 47th, on the basis of measures such as 26 percent adult illiteracy, 68 percent of population lacking access to safe water, and 30 percent of children under five being underweight. In gender terms, between 1990 and 1997 almost 90 percent of the female labor force remained in agriculture; the corresponding figure for men was 73 percent. In UNDP's Gender-Related Development Index, PNG ranked 107th among 143 countries due to substantial discrepancies between male and female adult literacy rates and real GDP per capita. On the Gender Empowerment Measure, PNG rated 91st in a listing of 102 countries, based on indicators such as female political representation and employment in managerial and professional occupations. Activity surveys in the agricultural sector typically show women working longer hours than men, while receiving less of any cash income earned.

Gender discrepancies are also very marked, with women very disadvantaged on measures such as income, education, and employment

The macroeconomy of PNG is extremely open and vulnerable to changes in world commodity prices, particularly for minerals. Since Independence in 1975 it has been regarded as a relatively high labor cost economy, the result of wage determinations made in the immediate pre-Independence period. These resulted in substantial urban wage increases, the real value of which was subsequently protected by automatic indexation against a consumer price index. This mechanism guaranteed that the price effects of any currency devaluation (in an urban economy where a large proportion of "wage-goods" were imported) would flow directly through to the consumer price index and hence to nominal urban wages. Consequently, the main thrust of macroeconomic policy until the early 1990s was toward maintenance of the external

1 The Gini index appears in the literature, for example, the World Bank (1999) and UNDP (1999), with a value between 0 and 100. This indicator is essentially the same as the Gini coefficient, with a value between 0 and 1.

2 Information in this and following paragraph are drawn from UNDP (1999) and World Bank (1999).

value of the kina, to avoid an import-induced wage-price spiral and the further loss of international competitiveness. This “hard kina strategy” was largely successful in securing macroeconomic stability, but was criticized as inhibiting economic growth. Agricultural producers were penalized by an overvalued exchange rate, while import substitution in a range of wage-goods, including fresh food, was suppressed.

These policy settings were altered dramatically, first by a Minimum Wages Board determination in 1992, which established a new and substantially lower urban minimum wage for new job entrants, while dispensing with automatic wage indexation. Then in 1994 the kina was allowed to float, when a period of fiscal indiscipline made defense of the exchange rate no longer feasible. These two developments had a number of potentially profound effects. The kina exchange rate, which had been more or less on a par with the dollar in 1993, has declined almost continuously to slightly below 40 cents (April 2000). The reduction in real urban wages has been progressively working through the workforce, with consequent reductions in unit production costs. Reduced purchasing power of urban workers and higher kina costs of imported wage-goods have also stimulated some expansion of domestic production, visible, for example, in increased supplies of fresh foods in urban markets.

These developments are proving favorable to the “commercialization” of fresh food production, and to the emergence of a range of microenterprise-level ventures in food processing and petty trading. Prior to the early 1990s, the substantial absence of informal sector economic activity in PNG had frequently been remarked by visitors familiar with the dynamism of this sector in other countries. The monetized informal economy, whether the urban informal sector or the rural off-farm sector, is still relatively stunted in PNG. However, the change in the economic environment which has occurred since the floating of the kina and the change in minimum wage fixing procedures is favorable to the emergence of indigenous microentrepreneurs, and will increasingly require the creation of a financial system geared to their need for capital and other financial services. Microfinance, which has been slow to take root in PNG, may prove to be of increasing relevance to the needs of Papua New Guineans who lack adequate access to the formal financial system.

1.2 Financial Sector

The Bank of Papua New Guinea (BPNG, the central bank) distinguishes four “tiers” among institutions comprising the formal financial system in Papua New Guinea (BPNG 1998a). At the base of the system is BPNG itself, the source of reserve money. The commercial banks, of which there are six, form a second tier of the system as the creators of secondary money. Of these six banks, four are the locally incorporated successors of Australian banks operating in PNG before Independence in 1975. One is a state bank, the Papua New Guinea Banking Corporation (PNGBC). The Australia and New Zealand Bank and Westpac Bank are both local subsidiaries of Australian private financial institutions, and the fourth, the Bank of South Pacific, is a nationally owned private bank acquired from Australian owners. During the 1980s, and as part of a conscious strategy by the central bank to increase competition and diversify the system, two non-Australian banks were granted licenses. These trade today as Maybank and Bank of Hawaii and are owned by Malaysian and United States interests, respectively. Despite the emergence of new financial institutions, described later in this section, the six commercial banks dominate the financial sector, accounting for about 90 percent of bank assets (AusAID 1998).

The commercial banks operate through branches, generally located in major urban centers, and sub-branches that are in smaller towns. The former provide a full range of banking services, while the latter generally provide all services other than overseas transactions. At a lower level are bank agencies that operate in more remote parts of PNG, providing only savings deposit and withdrawal services. Only two of

Recent macroeconomic developments, including exchange rate depreciation and a marked reduction in real wages, have stimulated the informal sector

Six commercial banks dominate the financial sector, holding 90 percent of assets

Banking outreach expanded substantially between Independence in 1975 and the early 1980s but branch closures have since reversed the trend

the commercial banks, PNGBC and Westpac, have any significant representation beyond the full branch level in major population centers. PNGBC was established in 1974, immediately prior to Independence, acquiring the assets and branch network of the Commonwealth Bank of Australia in the country. It was charged with what the central bank describes as:

... the potentially conflicting objectives of operating as a competitive, profitable commercial bank whilst ensuring that its policies were directed to the greatest advantage of the people of Papua New Guinea (BPNG 1998a, 128).

In pursuit of this mandate, PNGBC led a substantial expansion of banking outreach from 1976, which peaked in 1984. At that time the country was served by 60 branches, 35 sub-branches, and 407 agencies of commercial banks. However, as the result of circumstances described in Section 2.5, by 1997 this outreach had diminished to 52 branches, 25 sub-branches, and only 87 agencies. It is fair to say that, for rural and remote areas in particular, PNG was substantially “de-banked” in a steady process of attrition between 1984 and 1997. The implications of this for financial development in general, and for microfinance more particularly, are discussed later. At the end of 1997 the total assets of all commercial banks amounted to slightly more than K3 billion (around \$1.8 billion at that time).

On the third tier of the financial system are “bank-like” institutions. These include finance companies, merchant banks, and savings and loan societies (S&Ls). They are financial intermediaries, which mobilize savings and channel credit to private borrowers but are not permitted to offer checking services. There are five finance companies, three of which are subsidiaries of commercial banks. Of four merchant banks, three are foreign owned. The S&Ls originated in the colonial period and date from the early 1960s. After an early phase of quite rapid growth, the societies have undergone considerable difficulties, which are discussed in Section 2.3. Total assets of this third tier of institutions amounted to K279 million at the end of 1997 (around \$170 million at that time).

Finally, there is a fourth tier, of nonbank financial institutions (NBFIs), which BPNG distinguishes from the “bank-like” institutions in the third tier (BPNG 1998a). These include investment and pension funds, insurance companies and brokers, stockbrokers, and the Rural Development Bank of Papua New Guinea (RDB). Despite its name, RDB is regarded as an NBFIs because it is not a deposit-taking institution. It was originally established in 1967 as the Development Bank of Papua New Guinea, following recommendations by a World Bank mission in 1963, and assumed its current name in 1994. Its primary objective was to finance primary production, and a commitment to the needs of small-scale borrowers has always been among its objectives. The bank was capitalized by government grants through the national budget and has remained as a credit supply institution, although it is permitted to offer deposit services under its charter. By 1994 it had 4 regional offices, 6 branches, and 17 representative offices (BPNG 1998a), although this number has declined more recently.

Savings and loans societies grew rapidly from the early 1960s, but the system has experienced considerable difficulties

In terms of financial deepening, the ratio of Broad Money (M3*) to nominal GDP increased fairly steadily from around 25 percent at Independence in 1975 to slightly more than 40 percent by 1990 (BPNG 1998a, Fig.5.5)³ This can be regarded as a proxy for the degree of monetization or financial intermediation occurring in the economy. A period of fiscal excess then saw the ratio decline consistently for the next five years to around 33 percent, following which it appears to have increased again, reaching a new peak of around 45 percent by 1997. As another indicator of financial deepening, the central bank cites a fairly steady decrease in the ratio of currency in circulation to total bank deposits between 1978 and 1997 (BPNG 1998a).

3 BPNG regards as most suitable for this purpose a Broad Money measure (M3*), which is defined as M3 less the deposits held by commodity stabilisation funds.

2 Development of Microfinance

Microfinance in Papua New Guinea has been subject to a considerable degree of scrutiny, considering the small number of institutions involved, their short histories, and their limited outreach.⁴ For an understanding of difficulties attending financial sector development in this country, it is necessary to remember that colonialism came late to PNG, and the end of the colonial era was correspondingly delayed until the mid-1970s. The existence of substantial highland populations was not discovered by the colonial authority until the 1930s, and external administration, the Pax Australiana, was established only in the 1950s among certain major population groups.

Particular features of the traditional economy included a low-level equilibrium of subsistence agricultural production, founded primarily on tubers as the staple crop. The people had relatively abundant land resources and employed comparatively simple techniques of production requiring minimal capital accumulation or investment. Production levels were set by the maximization of returns per unit of labor, rather than per unit of land, in the context of a simple set of known production possibilities and modest consumption aspirations. Prior to the second half of the nineteenth century there was an almost total absence of external trade or contact with industrial societies, or indeed with the adjacent wet-rice cultures of monsoon Asia. Even into the 1950s, in much of the interior, patterns of internal trade reflected local resource endowments and were conducted largely by barter.

Such capital accumulation as occurred (remembering the predominance of perishable root crops in the pattern of production) was primarily for social/political purposes, involving the exchange of foodstuffs and valuables between individuals or groups. For most of these small societies there was no generally accepted medium of exchange; traditional valuables seen by outsiders as a form of proto-money, such as shells or plumes, had a primarily ceremonial significance. Similarly, notions of credit and debt, while present in traditional society, were for most groups intertwined with the web of social relationships and obligations. They were not seen as impersonal, contractual relationships of the kind entered into by bankers. And while the notion of paying “interest” (in some sense) was also not unknown, relating the payment of “interest” to the time period of a loan was entirely foreign.

This is the cultural context into which the intrusion of the world economy required the introduction of money and a financial system. Any judgment about the slow progress of financial sector development in PNG must take into account the

Difficulties of financial sector development in PNG are partly related to colonial history

Issues in financial sector development in PNG

Any judgment of the slow progress of financial sector development in PNG must take account of:

- the relatively short history of the country’s contact with the international economy
- the absence of any monetary system in the traditional economy
- the still uncompleted process of monetizing subsistence economic activities on which a majority of the population continues to depend.

⁴ See, for example, the following reports: NZODA (1993), UNDP (1995), AusAID (1996), Belloni (1996), Lacson and Zacarias (1996), ADB (1998) Hickson et al. (1998), ADB (1999), AusAID (1999). There have also been workshops; see BPNG (1996) and Kum-Gie Consult and Friedrich Ebert Foundation (1998). For journal articles, see Fleischer (1996), Kavanamur and Turare (1999), Kopunye et al. (1999), Bablis (1999), and Gregory (1999). For discussions of the feasibility of microfinance in a broader Pacific context (including Papua New Guinea) see Foundation for Development Cooperation (1996) and McGuire (1996).

The demand for microfinance is inhibited by the limited extent of monetized informal sector production

relatively short history of the country's contact with the international economy, the absence of any monetary system in the traditional economy, and the still uncompleted process of monetizing subsistence economic activities on which a majority of the population continues to depend.

Further, any judgment about the potential for sustainable microfinance in PNG must take into account the still quite limited development of "informal sector" economic activity, as already mentioned. The substantial absence of the complex and diverse set of micro-enterprise activities by which landless or land-deficient people sustain themselves in monsoon Asia, and for which access to microfinance services helps to increase productivity and incomes, is a distinctive feature of PNG and the small island states of the Pacific more generally. One commentator (Gregory 1999, 85, 89) has gone so far as to claim that microfinance is an inappropriate response to PNG's poverty problems, since "it is a solution to a problem that has its origins in a rice culture," whereas PNG has a "root-crop culture" in which "most people have no economic need to engage in a variety of penny capitalist activities in order to survive on a day-to-day basis."

Nevertheless, after a period of nongovernment organization (NGO) and government experimentation with microfinance based on international principles, discussed later in this section, it appears the time has come for microfinance to be included explicitly in government policies for financial sector development and the "economic integration of marginalised households in PNG" (DTI n.d.). This new development is discussed in the next section.

2.1 Government Microfinance Schemes

The central and some provincial governments, with the assistance of regional and international agencies, have trialed small microfinance initiatives for women since the 1980s (see Hickson et al. 1998). Although there were earlier women's credit schemes, perhaps the first project with some characteristics of modern microfinance was the Women's Credit Project initiated in two provinces in 1988 by the Asian and Pacific Development Centre, with the assistance of the South Pacific Forum Women's Bureau. A number of provincial governments subsequently followed this example to institute parallel programs, and UNDP provided some technical assistance. By the end of 1995 some 380 loans had been made totaling almost K90,000, with a mean loan size close to K240 (around \$180 at that time). Performance generally was poor, with the exception of the Western Highlands provincial project, "which placed a high and sustainable interest rate on loans, kept good records and assiduously pursued clients for repayments" (Hickson et al. 1998, 13).

Governments have combined with international agencies to initiate early microfinance schemes

In 1995 the Department of Home Affairs set guidelines for these women's microcredit schemes and, with technical and funding assistance from the New Zealand government, commenced a new phase of the program. There appears to have been some disagreement about the rate of expansion, with the New Zealand Overseas Development Assistance (NZODA) favoring a more gradual approach. Although the New Zealand government did not provide further support, the Government of PNG committed additional funds during 1996. In 1997 the National Council of Women, in an effort to encourage sustainable operations, set a lending rate of 10 percent per annum flat for loanable funds provided to provincial women's councils, which were in turn permitted to charge up to 20 percent per annum flat to borrowers.

In 1997, as a condition of a structural adjustment package agreed with the World Bank, K2 million (about \$1.15 million) was provided by the central government for expansion of the Women's Credit Project to all provinces of the country. This appears to have been designed to ameliorate the impact of the structural adjustment measures on the poor. However, the disbursement of funds occurred with little notice

Draft National Policy for Microfinance

A draft national policy for microfinance agreed in March 2000 aims to bring micro-enterprise and SME into the economy, through financial services, by:

- upgrading MFIs to sustainability
- down-scaling products of financial institutions to suit a mass market
- facilitating private enterprise service providers
- encouraging best practice in financial operations
- observing best practice in subsidization and technical assistance
- supporting a national microfinance network.

or preparation. A 1998 newspaper article (quoted in Hickson et al. 1998) reported that the PNG auditor general had asked provincial authorities for an accounting of these funds, since no information on their distribution or repayment had been provided to the Government. No data were available from the relevant central government agency at the time of the writer's visit in 1999, although it was suggested that most of the funds are still held in interest-bearing deposits by local women's credit associations, pending guidance on operational procedures from central government.

The Asian Development Bank (ADB) held consultations on microfinance in March 2000 with the Government, provincial governments, MFIs, commercial banks, S&Ls, and BPNG, among other parties. This resulted in agreement on a memorandum of understanding on potential areas for cooperation in microfinance development and employment creation. These included capacity building and the development, testing, and implementation of new savings and loan products (ADB 2000). As a further result of this mission, an interdepartmental group of government officials prepared a draft microfinance policy for PNG (DTI n.d.). The Department of Trade and Industry (DTI) has been given carriage of this policy, including its further development for cabinet approval.

The government draft policy document for microfinance builds on previous government policy stressing private sector development, and states as an objective "enhanced economic integration of micro, small and medium enterprises through better access to sustainable financial services." It lists provision of savings services as a further goal. The document states the overall objective of the policy as being "to provide a framework for existing and future institutions to either upgrade existing credit schemes or downscale financial products towards mainstream [that is, mass market] financial services."

Concerning the role of government in these processes, the draft declares that "[u]nderscoring its private sector orientation, the Government of PNG understands its role as a facilitator for private service providers." It sets out best practice principles for the provision of microfinance services by MFIs and other financial institutions, and for the manner and extent of any subsidization by government and external agencies. Finally, the draft welcomes the initiative for a national microfinance network, formed to represent the interests of stakeholders in microfinance. These developments and the potential for cooperation with ADB could stimulate a quantum leap in the level of microfinance activity in PNG, and would have implications for the operations of a range of financial institutions, including BPNG.

Microfinance was inserted into a structural adjustment package in 1997, with unfortunate outcomes

2.2 NGOs in Microfinance

The previous discussion of government initiatives in microfinance mentioned the role of the nongovernment National Council of Women as an implementing agency. As in

Partnerships between government and NGOs have been common — Liklik Dinau is the best known case

many other countries, the distinction between government and NGO-initiated microfinance activities is not clear-cut. Partnerships are quite common. This is certainly the case with Liklik Dinau (“small loan” in Tokpisin, the creole which is the vernacular for most Papua New Guineans). Liklik Dinau is the best known and most documented NGO engaged in microfinance in PNG. Liklik Dinau emerged from the collaboration of seven parties, including government departments, PNGBC, UNDP, the National Council of Women, and the Foundation for Law, Order and Justice, the latter two both private entities.

These parties formed a trust (the Liklik Dinau Abitor Trust) in 1994. The trust deed establishes Liklik Dinau’s mission to assist very poor households to raise themselves from poverty and to achieve greater self-reliance. The poor are defined as those from the bottom 50 percent of the income distribution. Liklik Dinau was founded explicitly to replicate the Grameen Bank model of microfinance in the context of PNG (Fleischer 1996). UNDP provided technical assistance in 1993–1994 for a feasibility study, and it has subsequently provided technical personnel, having posted several UN volunteers to assist the project.

Liklik Dinau offers a standard one-year loan and both voluntary and compulsory savings accounts. Activities are group based, with contiguous groups federated into centers. This is not easy to manage since population densities are relatively low and fieldworkers have high ratios of travel time to client contact and deal with relatively small numbers of borrowers, both per center and per working week. Group members receive training before they take out loans and Liklik Dinau attempts to use the mechanisms of group liability and peer pressure as a substitute for collateral. In 1999, first loans were up to K350 (say, \$160) with subsequent loans increasing to a maximum of K1,000 (then around \$450). Loan sizes are more varied than in the standard Grameen model, where first, second, and subsequent loans follow a quite rigid progression. This has complicated Liklik Dinau’s accounting and record-keeping processes.

Liklik Dinau has attempted to replicate the Grameen model in PNG

Both compulsory and voluntary savings are collected. There is a compulsory “group fund” with standard weekly contributions and automatic deductions of 5 percent from each loan. This fund is available for borrowing by members in emergencies, with group approval. There is also a “mutual aid” fund, established as a life insurance scheme, membership of which is compulsory. In addition, there is a small “default” fund, to which members contribute on a weekly basis. Finally, there is also a voluntary savings fund that collects only from members. In 1999 these voluntary savings carried interest at 5 percent per annum and depositors were not subject to any minimum balance or minimum deposit requirements such as commercial banks impose in PNG. This is a considerable benefit for small savers.

The savings performance of Liklik Dinau members is one of the most positive aspects of this MFI’s performance. The UNDP review of 1998 (by Hickson et al.) found that accumulated savings (at K75,000) were some 55 percent of the outstanding loan portfolio. However, the most recent review (AusAID 1999) expressed concern that savings held by Liklik Dinau on behalf of members are not sufficiently quarantined from the MFI’s operating budget. There was no separate account for savings held in a commercial bank, nor was any savings reserve fund established to meet contingencies.

The savings performance of Liklik Dinau members is particularly good

At the time of AusAID’s review (February 1999), Liklik Dinau was experiencing a liquidity crisis thought likely to threaten its survival. This was not the first time this MFI has been in such a situation. Its first evaluation, conducted by Lacson and Zacarias (1996) in April 1996 after two years of operation, concluded that only K50,000 remained from the initial capital base of K150,000. On that occasion, further commitments by AusAID and the Government of PNG restored the loanable funds of Liklik Dinau to an operational level. Similarly, after the AusAID review in 1999, the Government of Australia committed a further A\$1.2 million over a three-year period to 2002. This support has been provided conditionally, with the requirement that Liklik Dinau meet

stated performance targets, with a twice-yearly reporting schedule. Progressive improvements in sustainability and other indicators will be required (AusAID 2000).

Another review of the program by UNDP in mid-1998 (Hickson et al. 1998) calculated that Liklik Dinau was then covering only 17 percent of its operational costs and 11 percent of its operational and financial costs. Grants received by Liklik Dinau were assigned an opportunity cost of 10 percent per annum for the purposes of this calculation. The AusAID review of 1999, on the basis of assumptions about increased staff productivity, predicted an operational sustainability ratio of between 40 and 50 percent by the end of 2001. The report concluded that if donors intended to put Liklik Dinau on a sustainable footing, support well beyond three years would be required. This presumably is the assumption on which AusAID's current three-year program of assistance is predicated.

Outreach of Liklik Dinau in April 1998 totaled 862 active borrowers served by its two branches in the Eastern Highlands province. The loan portfolio outstanding totaled K136,000 (around \$66,500 at that time). The then net value of the Liklik Dinau program was estimated at between K50,000 and K63,000, compared with cumulative contributions totaling K0.66 million since 1993 by donors, governments, and individuals (Hickson et al. 1998).

This evaluation noted that while portfolio growth had been slow over the life of the project, recovery of principal, interest, and mandatory payments had been only 81 percent of the amount due, and that about half of all current borrowers were in arrears. Portfolio at risk was calculated at around 60 percent. A program dropout rate of more than 40 percent and the small proportion of second-time borrowers were sources of concern. The review noted the restricted range of economic activities for which loans were being made as another source of weakness. An interest rate of around 60 percent per annum (or 1 percent per week) on outstanding loan balances was thought necessary to assure full operational and financial sustainability in the longer run. This compared with the effective interest rate gained by the project, then about 55 percent per annum.

This account of an MFI which secured outreach of only 862 borrowers after four years in operation might seem excessively detailed, except that the experience of Liklik Dinau provides valuable insight into the conditions in which microfinance must operate in PNG. Liklik Dinau's progress to sustainability in future should be regarded as problematic; it is reassuring that AusAID appears now to have made a commitment to that objective and that it has conditioned its support on a series of verifiable performance targets.

Operational sustainability is still a distant prospect

Repayment performance is poor, dropout rates are high, and second-time borrowers are few

The Instructive Experience of Liklik Dinau Abitore Trust

Liklik Dinau's experience illustrates many of the important issues for microfinance in PNG.

- Low population densities raise travel costs and reduce fieldworker productivity.
- Following standard Grameen procedures can be difficult in PNG.
- A limited range of perceived economic opportunities can put a ceiling on credit demand.
- As a result, dropout rates are high and repeat borrowers are few; arrears are also high.
- The most positive feature is the very good savings performance of clients.
- Optimistic assumptions put Liklik Dinau at between 40 and 50 percent operational sustainability by end-2001.

NGOs have taken the initiative to set up a national microfinance forum

A number of other NGO microfinance programs are or have been in operation, including PnK (Putim na Kisim, “put in and take out” in Tokpisin). This program has the advantage of being based on a long-running agricultural/enterprise development program operated by Lutheran Development Services in northern provinces of the New Guinea mainland. It is probably too early to make an assessment of the effectiveness and sustainability of this rather decentralized set of activities. The Government’s draft policy statement on microfinance (DTI n.d.) has welcomed an initiative led by NGOs to set up a forum or network for national stakeholders in microfinance, which would establish a mechanism for coordination and consultation between government, donors, and NGOs. Any microfinance strengthening project supported by ADB could usefully assist with this process.

2.3 Savings and Loans Societies

Australian banks had operated in the colonial Territory of Papua and New Guinea since 1916 as an extension of the Australian banking system, to serve an enclave economy consisting, in the pre-war period, of the colonial administration, plantations, and Christian missions. In 1960 the newly created Reserve Bank of Australia (the Australian central bank) opened a branch in Port Moresby which was later to become the central bank of an independent Papua New Guinea. In 1961 the Reserve Bank announced “a program of education in money, savings, banking and credit” for Papua New Guineans and posted an officer to Port Moresby with responsibility for “special duties, monetary development” (May 1998, 6–8). Again in 1961, a Savings and Loan Societies Ordinance was passed in the Territory legislature. The intention was to establish S&Ls as a “type of ‘pre-banking’ system,” which alongside the conventional banking system would encourage the habit of thrift among Papua New Guineans, educate them in financial management, give access to small loans, and contribute to capital formation (May 1998). May (pp. 20–21) says of this initiative:

S&Ls were established as a kind of “pre-banking system”

The [savings and loan] movement enjoyed a rapid growth during the 1960s. Although the more successful societies were concentrated in Port Moresby and Rabaul — where better educated Papua New Guineans provided both a pool of relatively skilled manpower and source of income and demand for loans — adventurous young field officers enthusiastically set up savings clubs and societies throughout Morobe and the highlands (some of which could not be located years later). By the late 1960s, the movement was represented in 15 of the country’s 18 districts.

Unfortunately, even before the close of the 1960s, problems had become apparent, and by 1979 only 40 of the 165 societies then registered were active. By 1992 virtually all rural societies had ceased to operate and the movement was essentially urban in character (BPNG 1998a). In 1997, according to the annual report of the registrar of S&Ls (BPNG 1998b), 103 societies were registered with some 114,000 members and total assets of K141 million (around \$80 million at that time). However, only 21 of these societies were active by then and 82 were dormant. Some 57 percent of the listed membership and 84 percent of the funds were in the 21 active societies. The report provides no data on the gender composition of the membership. This omission makes it difficult to evaluate the suitability of S&Ls as vehicles for microfinance, given the importance for women of access to microfinance services in other countries.

Despite rapid early growth, the S&L system soon ran into difficulties

May quotes an observer from the late 1960s who believed that poor understanding of S&L operations and “chronic” non-repayment of loans had “tended to undermine the societies’ reputation and image among members.” A more recent judgment (in ADB 1999) also cites “flawed” policies as a reason for their downfall. These included caps on interest rates and loan size limits. May’s judgment of this earliest attempt to introduce microfinance services to the indigenous population of PNG was that:

The development of the savings and loan movement represented an early and innovative initiative in attempting to develop financial institutional arrangements appropriate to the needs of Papua New Guineans, at a time when the commercial banks ... showed almost no interest in the development of a Papua New Guinean clientele (May 1998, 23).

In 1992 BPNG announced a “revitalization program” which called for the liquidation of dormant societies and for the operations of active societies to be strengthened. The umbrella body for S&Ls, the Federation of Savings and Loan Societies, was also to be “overhauled.” In these activities BPNG has received assistance from the World Council of Credit Unions and the Credit Union Foundation of Australia.

In 1995, amendments to the Savings and Loan Societies Act were introduced. The governor of the central bank became the registrar of savings and loan societies, giving the central bank authority to supervise and monitor S&Ls directly. In addition, the membership requirement for a new S&L was increased from 20 to 500 members, and the registrar has authority to direct an S&L to become a licensed financial institution, should the scale or nature of its activities warrant this. As before, the maximum lending rate for S&L loans is capped at 1 percent per month on the reducing balance, or at 6 percent per annum, flat. Individual S&Ls are able to determine the deposit rates paid to members. These appear to range between 2 and 10 percent per annum, with the majority being set at around 4 to 5 percent. Some S&Ls also charge a one-off loan fee of 0.5 percent, but the margins allowed by the Act (because of the interest rate cap) do not appear adequate for sustainability, unless labor is supplied very largely by volunteers.

Under the new legislation, duties and responsibilities of the managers of S&Ls are defined more clearly, the liquidation and winding-up process was made simpler and less time-consuming, and the governance requirements for S&Ls were reformed. Under a technical assistance project jointly funded by BPNG and the Credit Union Foundation of Australia, computerization of S&Ls commenced and the active involvement of employer and/or local government interests in the activities of S&Ls was encouraged. These processes continue to the present.

The savings and loans movement represents by far the largest and most widespread activity to date in PNG which has had any of the characteristics of microfinance. It was dedicated to reaching people not served by the formal financial system, and conceived quite explicitly by the Reserve Bank of Australia as an exercise in financial sector development. It encouraged small deposits and made small loans

The central bank, BPNG, has set out to revitalize S&Ls

Legislation in 1995 restructured S&Ls, but interest rate caps were retained

The governor of BPNG is now the registrar of S&Ls, with supervisory powers, and technical assistance is being delivered to the societies

Overview of Savings and Loan Societies Experience in PNG

- S&Ls were established by the colonial government in the 1960s as a “pre-banking system.”
- They were intended to accelerate monetization of the subsistence economy.
- They expanded rapidly during the 1960s, but were in decline by Independence in 1975.
- The best S&Ls were largely restricted to the urban salariat and prosperous cash crop producers.
- They have been undergoing “revitalization” under central bank tutelage since 1992.
- Reforms in governance and supervision are in progress but lending rates are still capped.
- Opinions differ concerning the capacity of S&Ls to become more inclusive and sustainable.

for a range of purposes, including for production. However, the members of S&Ls were scarcely the poor in the PNG context, since societies came to be concentrated among the urban salariat, while its rural successes (such as they were) occurred in relatively well-favored areas where cash cropping had been introduced. It operated (and continues to do so) within a regime of interest rate controls which allow margins probably insufficient for sustainability even under circumstances of efficient operation. The reasons for its failures include mismanagement and malpractice on the part of the management and boards of S&Ls, which the 1995 amendments to the S&L Act concerning society governance are intended to address, and inadequate supervision, for which the central bank has now accepted greater responsibility. Inappropriate policies have also contributed to their unsustainability.

The new or resurrected S&Ls are being set up primarily as savings institutions, at least initially, while loans are now being secured against the borrower's savings. While the main focus is the urban salariat, this is not exclusively so. The East New Britain S&L had almost 9,000 members in September 1998, of whom 65 percent were self-employed and living in the wealthy rural hinterland of Rabaul. Membership savings totaled more than K5 million (or around K550, say \$240, per member) (Tololo 1998, quoted in Kavanamur and Turare 1999).

Opinions differ on the potential of S&Ls for broadly based micro-finance, but interest rate controls clearly constrain that potential

With regard to the longer term prospects of S&Ls and their potential to contribute to the provision of microfinance services nationally, there are conflicting views. Belloni (1996) regarded S&Ls as having the potential to occupy only a narrow urban niche where public servants and private sector employees receive regular wages and have continuity of employment, and where the employer is prepared to provide subsidies in the form of various forms of support for the S&L society. Another consultant (ADB 1999) was much more optimistic about the potential for S&Ls to serve as grassroots MFIs, providing certain mistaken policies (primarily to do with interest rate caps) are corrected. Responsibility for S&Ls lies with the central bank, which has the authority either to lift the interest rate cap (now at 6 percent per annum flat, or 1 percent per month on the unpaid balance) on S&L lending, or otherwise to raise it to a level more consistent with sustainability.

2.4 Development Banking and Microfinance

As already mentioned, the Development Bank of Papua New Guinea was established in 1967. This was renamed the Agricultural Bank of Papua New Guinea in 1985, a change designed to "reinforce its emphasis on the development of small- to medium-scale agricultural projects and enterprises" (BPNG 1998a, 145). The Agricultural Bank experienced difficulties with nonperforming loans in the late 1980s due to the collapse of world commodity prices, and throughout the decade and into the early 1990s its administrative costs exceeded its loan disbursements in most years. In 1992, administrative costs of K11 million were incurred in order to disburse loans of K13 million. Some 360 staff were responsible for disbursing loans to only 1,900 borrowers (Kannapiran 1995). A second restructure occurred in 1994 and the bank was renamed the Rural Development Bank of Papua New Guinea (RDB). This was necessary because of the financial condition of the bank. As BPNG notes (1998a, 146):

Between 1992 and 1995 the Bank was technically insolvent reporting negative shareholders' funds for four consecutive years. A principal factor undermining the Bank's viability has been the maintenance of subsidised, constant nominal interest rates.

The central bank cites a 1988 study which concluded that subsidized lending by the former Agricultural Bank, rather than benefiting small farmers, had flowed principally to politicians, civil servants, and large businessmen. BPNG comments that "two changes of name have done little to increase the proportion of new lending going towards agriculture." As part of efforts at restructuring and reform, in 1998 RDB

became a subsidiary of the state commercial bank, the Papua New Guinea Banking Corporation (BPNG 1998a). During 1999 RDB had ceased retail lending and was concentrating on the collection of overdue loans. It has applied to BPNG for approval to take deposits when it resumes retail operations.

There were limited attempts by RDB to engage in very small loan financing and microcredit. From 1994 it introduced a Women and Youth Mini Loan Scheme with a maximum loan of K2,000 (\$1,500) and a mean loan size of K1,900. This carried an interest rate of 4 percent per annum flat, compared with the market rate at the time of 10 to 12 percent (Kavanamur 2000). However, what one observer (ADB 1999) described as “massive defaults and the unrealistic pricing of mini-loans” exhausted the fund, and it closed in 1997.

A second scheme was the Small Holder Agricultural Credit Scheme, established in 1996. By September 1998 some 1,580 loans had been approved with a mean loan size of some K3,000 (\$2,200). A third scheme, the Oro Small Business Credit Scheme, commenced operation in 1998. To July 1998, 105 loans with a mean value of K3,700 had been disbursed (Kavanamur 2000). If we accept the rule of thumb that an average microcredit loan could be about one half of a country’s per capita GDP, an average loan size of about K1,100 (then about \$550) would have been appropriate for 1998. On that basis none of the three RDB loan schemes described here appears to qualify as microfinance.

In 1998 RDB announced its intention of initiating an explicit microcredit scheme. Unlike the small loan schemes previously described, in which the bank lent directly to small borrowers, the proposed RDB microcredit scheme appears to have been influenced by international microfinance experience in that it proposed to give priority to women borrowers, reduce transaction costs by lending through intermediaries, charge interest rates closer to sustainable levels, and impose savings requirements on borrowers. Intermediaries were to receive credit up to a maximum of K5,000 for a term of one year with a grace period up to three months, and at a 10 percent per annum flat rate of interest. It was proposed that these intermediaries would lend up to K500 to individual borrowers for a term of one year, with a grace period of up to three months, and at a rate of 20 percent per annum flat. Documentation for the scheme (Rural Development Bank 1998) indicates that both lending and on-lending rates were to have been adjusted in accordance with market conditions.

RDB was prepared to consider business enterprises, moneylenders, self-help groups, and NGOs as intermediaries. An advertisement for intermediaries produced around a thousand expressions of interest, from which a small number were selected for a pilot project. Borrowers were to have been required to hold at least 10 percent of the requested loan amount in a savings deposit with PNGBC. No link with saving had been made in any of the previous loan schemes administered by RDB. An initial budget of K0.5 million was proposed for 1999, for lending to “at least 1,000 micro-enterprise projects” under the pilot project. In fact, this proposal has since been abandoned; RDB is not to enter the field of microfinance, but will concentrate instead on reconstruction and a return to its core business of agricultural financing. It would, however, be interesting to see some of these principles trialed by another institution in PNG in future.

2.5 Commercial Banks and Microfinance

As mentioned in Section 1, there has been a substantial decline in the outreach of commercial banks since the mid-1980s. The central bank (BPNG 1998a) cites as reason for this a period of consolidation in the mid to late 1980s as agency numbers contracted due to insufficient business, but it also notes misappropriation and law and order concerns cited by the banks. Other factors cited for the 1990s include the

The Rural Development Bank has a checkered history

Limited attempts at microfinancing have occurred, but RDB has never accepted deposits

RDB will not persevere with microfinance, and will return to the core business of agricultural credit

Bougainville secession issue from 1990, loan losses following the commodity price collapse of the late 1980s, volcanic eruptions in Rabaul in 1994, and an increase in law and order problems. This has not been a favorable period for the emergence of commercial bank microfinancing.

In fact, the commercial banks in PNG have had little involvement with microfinance. The four main banks with more substantial branch networks have participated in several small business financing schemes, by virtue of a combination of government suasion and financial incentives. These include the Small Business Guarantee Facility and the PNG Government Credit Guarantee Scheme. Both are aimed at financing small- to medium-size indigenous business and have no particular relevance for microfinance.

Commercial bank outreach has declined and the banks have done little real microfinancing

In terms of normal commercial bank lending, some quite small “character-based” lending occurs. PNGBC will make small unsecured loans as low as K500 (\$200), although normally K1,000 is the lower limit. Some such loans are for purposes of self-employment but the great majority are for consumption purposes, including school fees. PNGBC feels quite strongly the need to “get out” of this high-cost personal lending, which in any case does not have the character of microfinance. Under legislation passed in 1998 (Independent State of Papua New Guinea 1998), PNGBC was corporatized, with a view to its eventual privatization. The legislation stipulates that “so long as the majority ownership ... is held by the State, one of the basic objectives of the company ... shall be to perform its functions and direct its policies to the greatest advantage of the people of Papua New Guinea” (Independent State of Papua New Guinea 1998, Sec. 42 (2)(c)). This obligation also carries an entitlement for the bank to be compensated for the cost of complying with government directives directed to the “greatest advantage” of the people.

Thus, PNGBC retains in its charter the elements of social obligation with which it was created, despite plans for its privatization in the near future. It has been involved with attempts to establish particular private MFIs, notably Liklik Dinau (discussed in Section 2.2). In addition, in 1998 PNGBC established a wholly owned subsidiary, Village Finance Ltd (VFL), with an initial capital of K1 million (then \$0.5 million). It allocated K0.4 million for initial running costs and pledged to maintain this operating subsidy for nine years, during which time the capital base will also be enlarged. In 1999 VFL obtained a financial institutions license from BPNG with the explicit requirement for it to target the “underprivileged.” The license further requires VFL to plow back all profits, without distribution to the sole shareholder. This appeared to be an acknowledgment by PNGBC that it has difficulty achieving the necessary “down-scaling” to enable it to serve remote and low income people directly.

The state commercial bank, PNGBC, has assisted Liklik Dinau and established a microfinance subsidiary, VFL

Following a visit to the operations of the Foundation for International Community Assistance (FINCA) in Uganda by the managing director and a senior official of PNGBC, their intention is to expand VFL using the FINCA village banking model (UNIFEM 1996). While initially there was some suggestion that VFL would take over the operations of Liklik Dinau, this did not occur and the two institutions are to operate separately. VFL has, however, made a loan of K150,000 to the Liklik Dinau Abitore Trust for a term of six years to provide seed capital to replenish loanable funds.

Beginning 1999, VFL planned to expand its operations at the rate of three branches per year. It had a core staff of project development officers to set up these branches. They are contracted initially for a period of three years with remuneration based on performance. Staff are generally young and relatively well educated, and are not drawn from the financial sector. VFL’s financial institutions license enables it, in principle, to conduct all banking operations except foreign exchange dealings. It is not subject to interest rate control, nor is it required to observe either the minimum liquid assets ratio (MLAR) or the cash reserve requirement imposed by BPNG on the

Overview of Village Finance Ltd

- Created by PNGBC as its subsidiary, with the FINCA model in mind.
- Required to plow back profits for expansion of services.
- Licensed for all domestic banking services.
- Free to set own deposit and lending rates.
- Not subject to reserve requirements.
- Regulatory requirements similar to commercial banks, but less stringent reporting requirements.

commercial banks as monetary policy instruments.⁵ It has less stringent reporting requirements than the commercial banks. VFL intends to offer deposit facilities and, while it could offer checking deposits, has no intention of doing so for the time being.

VFL's first branch was established in 1999 in the Port Moresby settlement of Morata, where it offers microcredit and basic savings facilities. One reason stated for this choice of location was to counter the influence of pyramid savings schemes that were then attracting deposits from Morata and other locations in Port Moresby. (These schemes are discussed in Section 2.6.) Potential borrowers must complete a short training course and, upon successful repayment of an initial loan, are eligible for further training and larger loans. The intention is that project development officers from VFL will recruit and train local staff who will assume day-to-day responsibility for the branch after six months. Loans are to be targeted at households without wage and salary earners, and at women in particular. VFL has technical assistance for human resource development from an Austrian aid agency (*Allfinanz News* 1999).

As a consequence of new policy initiatives flowing from ADB's fact-finding mission to PNG in March 2000, attempts will be made to involve the commercial banks more closely in microfinance in future. The draft policy (DTI n.d.) refers to the desirability of "down-scaling" existing financial products to make them accessible to a mass market. Evidently, the intention is to persuade at least one of the commercial banks to trial this process. It is also understood that VFL is to raise the upper limit on its loans to a maximum of K30,000 (\$12,000). This may reflect government policy to increase credit availability to small and medium business. However, it is not consistent with a focus on microfinance, unless the presumption is that larger and more profitable loans will cross-subsidize genuine microcredit by VFL.

However, both of these innovations could prove to be misguided. Goodwin-Groen (1998) reported that few commercial banks in Asia which have been mandated to pursue "poverty lending" by government direction are able to do so profitably. They do it because they have to. And the experience of RDB suggests that the repayment rate of the "small-to-medium" loans is much worse than that recorded for microfinance in PNG. More promising is the suggestion that commercial banks and/or VFL should make efforts to secure linkages with informal savings groups in rural areas. This is discussed in Section 2.6 as a useful suggestion for restoring formal financial intermediation processes to rural areas.

VFL is free to set its own lending and deposit rates and has ambitious expansion plans

Commercial banks are to be encouraged to "down-scale" their financial products for microfinance clients but this may prove difficult

5 However, the first of these concessions is not necessarily an advantage in terms of profitability, since under recent monetary conditions in PNG the commercial banks have found it profitable to have substantial holdings of high-yielding treasury bills which satisfy the MLAR and are risk-free (unlike loans made to the public).

The withdrawal of formal services from the countryside has probably stimulated informal financial intermediation

2.6 Informal Finance

There is limited information about informal financial services in PNG, although the progressive withdrawal of formal banking services from wide areas of the country suggests that informal mechanisms must be operating to intermediate flows of financial resources in such areas. This is the more likely in situations (as in coffee-growing areas of the highlands) where substantial infusions of cash flow to smallholders on a seasonal basis. Also, where the bulk of subsistence production is non-monetized, there is a relatively large discretionary element in the disposal of the part of personal incomes earned in the form of cash. This also implies, as Fernando (1991) points out, a relatively high marginal propensity to save from cash income and considerable potential for savings mobilisation. These factors may provide an explanation of the relatively good performance of Liklik Dinau in savings mobilisation. It may also help to explain why much investment in small-scale activities can occur in the rural sector without resort to formal credit facilities. In association with policy initiatives flowing from ADB's fact-finding mission to PNG in March 2000, it has been suggested that informal savings groups (that is, kinship- or locality-related groups not affiliated with S&Ls) should be identified for linkage with either commercial banks or VFL, to increase the efficiency of these intermediation processes.

Fernando (1992) provides one of the few discussions of informal financial services in PNG. He noted that in rural areas the major sources of credit appeared to be members of borrowers' extended families and clans, and tradestore owners who extend credit for consumption purposes (although, far from being an exploitative rural class, they often became insolvent in consequence). Informal savings and credit groups also operate, known as *wok meri* ("women's business," in Tokpisin) and ROSCAs known as *Sande* ("Sunday," in Tokpisin). Sande are found mainly among wage earners in urban areas and on plantations, although they may occur in rural areas where there is a sufficient flow of funds. A small group will meet soon after the fortnightly payday to pool savings and sometimes make loans to members. Fernando noted the conspicuous absence of professional moneylenders in rural informal financial markets in PNG. There did, however, appear to be an emerging group of moneylenders in urban and peri-urban areas, who charged relatively high rates of interest over specified repayment periods.

Moneylenders have been emerging

Towards the end of the 1990s, the potential for informal financial intermediation, particularly in urban areas, appears to have increased. The strong response to RDB's advertisement for potential intermediaries to take part in its microcredit scheme was described in Section 2.4. On another occasion, a central bank official (Bran 1996, 3) reported:

In the last three years, the Bank of Papua New Guinea has received numerous enquiries from small businessmen and individuals with surplus funds wanting to establish moneylending operations. They want to ascertain whether such operations are within the requirements of the Central Banking Act and Banks and Financial Institutions Act. Such lending operations are usually directed at individuals or small businessmen at very high interest rates secured by a person's employment and regular pay deductions.

A number of incorporated companies are lending money, particularly in urban areas, without financial institutions licenses. This appears to be legal, so long as moneylending is listed in the "constitutions" of such companies. They are not permitted to accept deposits, but since their typically small size leaves them exempt from reporting and audit requirements, their operations are opaque. Their interest rates are unregulated, although maxima are specified in a Moneylenders Act. As suggested in the comment by BPNG, some operators have agreed automatic payroll deduction arrangements with employers, including some government agencies. This suggests their activities are becoming institutionalized.

More disturbingly, there has occurred a proliferation of pyramid schemes in PNG, commencing from 1998. As many as eight such schemes offering depositors monthly returns of 100 percent or more were active early in 1999. Some were incorporated under companies legislation although none had a banking license and their deposit taking was in breach of the Banking and Financial Institutions Act. The central bank was slow to move against these pyramid schemes, which attracted substantial deposits from elites as well as grassroots individuals. After a change of government in mid-1999 the domestic bank accounts of these operators were frozen. BPNG instructed a number of parties to repatriate money from overseas and to pay out depositors within three months. One such entity, U-Vistract, was brought to court on the petition of a depositor seeking its liquidation, with the central bank later taking over the case as plaintiff. A liquidation order was granted in April 2000, with liabilities estimated at K581 million (\$232 million) (O'Callaghan 2000).

Companies have been lending without financial institutions licenses

The growing significance of high cost moneylending operations in urban areas indicates some discontinuity in the range of financial service options available to people in PNG, and the failure of regulated institutions to meet their effective demand for financial services adequately. The rapid growth of pyramid schemes points to substantial private resources available for investment, but also to a limited appreciation, even among urban people and the elites, of the relationships between investment, rates of return, and risk. Of course, financial scandals and scams occur in many countries with more highly developed financial systems than PNG's. Nonetheless, recent developments in PNG must be seen as an impediment to financial sector development in general and to sustainable microfinance with it.

Pyramid schemes have caused heavy losses to members of the public

3 Role of the Central Bank

3.1 Mandate and Functions of the Central Bank

As previously discussed, BPNG evolved from the Australian central bank, the Reserve Bank of Australia. The Reserve Bank had established a branch in Port Moresby in 1960 and at the time of self-government, in 1973, this became BPNG. It was established by the Central Banking Act, 1973, which was modeled on Australian central banking legislation. The governor of BPNG was appointed by the head of state, while the minister for the Treasury (Department of Finance) appointed one or two deputy governors on the advice of the governor. The policy of the bank was determined by its board, whose members consisted of the governor, deputy governors, the secretary of the Treasury, and other members appointed by the head of state.⁶

As to the functions of BPNG, the Central Banking Act (as cited in BPNG 1998a, 95) stated:

Within the context of the general framework of the policy objectives of the government, the central bank shall ...

- ensure that its monetary and banking policy is directed to the greatest advantage of the people of Papua New Guinea; and
- direct its efforts to promoting monetary stability and a sound and efficient financial structure.

The central bank issued an annual monetary policy statement that had been approved by the treasurer (minister for finance). Such statements generally emphasized monetary stability, including the stability of the exchange rate, interest rates, and

The central bank, BPNG, is concerned primarily with monetary stability

⁶ This account of BPNG's powers and functions is drawn largely from BPNG (1998a).

BPNG was subject to overall government policy, and "fiscal excesses" occurred

prices. The central bank's pursuit of these objectives was subject to the overall policy objectives of government. While the board was normally responsible for determining policy, the minister could instruct it otherwise. In the ultimate, the head of state, acting on advice of the Government, would determine the policy to be adopted. However, in regard to the issue of its independence, the central bank itself (see BPNG 1998a, 122) preferred not to focus on matters of legislation and ministerial powers:

The Bank of Papua New Guinea has always recognised that the best way to ensure its views are accorded due weight is by establishing a strong reputation for objectivity in the advice it offers and for technical competence in the analytical work it undertakes.

This was no doubt a realistic approach in a situation of rational and responsible policy making, involving the Government and the Department of Finance on the one hand and BPNG on the other. It is a fair description of the situation that prevailed for most of the quarter century after the central bank's creation in 1973. Unfortunately, lapses in economic policy did occur. For example, the extent to which BPNG may finance central government budget deficits was specified clearly in the Central Banking Act. During the early 1990s, a period that BPNG itself describes as one of "fiscal excesses," the Government's borrowing limits from the central bank were exceeded and a macroeconomic crisis ensued. Greater central bank independence at that time might have ameliorated the situation.

Prime Minister Morauta, himself a former BPNG governor, came to power in July 1999, following which the situation of the central bank was reexamined. Amendments to the Central Banking Act of 1973 were made in April 2000 to enhance the independence of the central bank and its governor in both policy and administration. In future the chief objectives of BPNG will be price stability, with an explicit target inflation range, and the promotion of an efficient national and international payments system. Stricter limits on BPNG budgetary lending to the Government are to apply. The governor is to be appointed by the head of state for a fixed term, with transparent guidelines for any act of removal from office. BPNG is to publish semi-annual monetary policy statements.

BPNG employs indirect means of monetary management and has a good record of avoiding financially repressive measures

The monetary policy instruments available to BPNG include treasury bills, trading in which has become the primary instrument of monetary policy in recent years. The central bank also imposes a MLAR requirement on the commercial banks, which specifies the proportion of bank liabilities to be held in the form of cash, deposits with the central bank, and treasury bills. The MLAR has been more than simply a prudential requirement; until the early 1990s and the increased use of treasury bill trading, it served also as the principal tool of monetary management.

In 1995 BPNG introduced a weekly "kina auction" to replace the commercial bank discount facility as a means of managing short-term liquidity. However, the central bank has recently imposed a cash deposit requirement on commercial banks, requiring a proportion of commercial bank liabilities to be kept as a deposit with the central bank. While the movement from the MLAR to treasury bill trading and the introduction of the kina auction mark a move towards more indirect means of monetary control, this is to some extent contradicted by the introduction of cash deposit requirements for the commercial banks. With the exception of S&Ls, the central bank imposes no interest rate controls on the institutions it supervises. As previously mentioned, the Government has used subsidized credit from RDB and its predecessors as a tool to develop the agricultural and industrial sectors and to promote citizen ownership of business, and the central bank has become involved in several such schemes to a minor extent.

BPNG's relationship with the banking system is governed by the Banking and Financial Institutions Act, which covers the duties of commercial banks and licensed financial institutions, the licensing requirements, and issues concerned with supervision. The central bank supervises commercial banks and "bank-like" institutions (finance companies and merchant banks). BPNG also administers S&Ls under the

Savings and Loan Societies Act. Under amendments to this Act in 1995, the supervisory responsibilities of the central bank were increased, as discussed in Section 2.1. The central bank was not responsible for supervision of RDB prior to its incorporation into PNGBC, nor has it been responsible for supervision of superannuation and other “contract saving” funds, although both would have benefited from such supervision.⁷

3.2 The Central Bank and Financial Sector Development

BPNG has always seen itself as having a role in promoting financial sector development. Its 1975 annual report (cited in BPNG 1998a, 108) stated three objectives to that end:

- (i) localize the monetary and credit base;
- (ii) develop an efficient and relevant structure of financial institutions; and
- (iii) transform and adapt the operational practices of the financial system.

Its actions in support of these objectives include encouraging the Australian-owned commercial banks to incorporate as companies in PNG and to cater more directly for the financial service needs of Papua New Guineans. BPNG has encouraged more active liquidity management by the commercial banks and the emergence of short-term money markets. During the 1990s especially it supported the development of a PNG capital market, and it has supported the development of financial market infrastructure, taking an equity stake in a company established to computerize banking sector operations.

The need to improve the provision of financial services in rural areas has been a priority since the establishment of the central bank. Its primary activity in this regard has been its support for the savings and loans movement. More generally, the Government has pursued a “supply-leading” approach to rural finance.⁸ This has been characterized by such measures as:

... the creation of the development bank, subsidised interest rates and selective credit policies to channel credit to priority areas. The supply leading approach places emphasis on credit which, in Papua New Guinea, has been reflected in the many government schemes to increase its availability (BPNG 1998a, 147).

However, other instrumentalities including RDB, rather than the central bank itself, have been the Government’s preferred vehicles for such activities. BPNG has insulated itself fairly successfully from these “developmental” activities, with the exception of some relatively minor schemes in support of plantation redevelopment, interest rate subsidies (at the time of the commodities price collapse in the early 1990s), and small business development. Commodity stabilization funds and price support schemes, for which BPNG has been the Government’s banker, have been directed at stabilizing incomes and/or prices received by agricultural exporters, and have had macroeconomic stabilization as a major objective.

In summing up changes in its role over a quarter century since its foundation, BPNG believes that:

In conducting the traditional Central Banking functions of monetary policy and supervising the financial system, the Bank’s approach has become more orthodox over time. Monetary management has become less interventionist and the increasing resources devoted to supervision mirror the trend worldwide (BPNG 1998a, 121–22).

BPNG has pursued an active role in financial sector development but has largely insulated itself from government’s “developmental” activities

BPNG has avoided financially repressive measures for the most part

7 The National Provident Fund, a national private sector superannuation scheme, announced in March 2000 the need to write down its assets by 50 percent as the result of an audit. The financial record of RDB is discussed in Section 2.4.

8 In doing so, the Government was following the World Bank, which in a 1978 report suggested that “PNG presents a unique situation where financial institutions could take the lead in the development process rather than follow the developments in other fields” (cited in BPNG 1998a, 147).

Surveying the mixed record of achievement in fostering rural financial development, the central bank comments:

Twentyfive years of experience has highlighted the intractable nature of many of the problems constraining activity and expansion of the rural sector. For rural finance initiatives to be viable and successful they must be incorporated within an integrated approach to rural development.

However, given its “orthodox” interpretation of its own role, BPNG has seldom been tempted (as just noted) to employ its resources in direct financing of such rural development.

4 Central Bank Support for Microfinance Initiatives

BPNG staff have been sympathetic but non-interventionist in regard to supervising microfinance activities

4.1 Perceptions of the Central Bank about Microfinance

Central bank staff in the Bank Supervision Department and the Registry of Savings and Loans Societies appear sympathetic but non-interventionist in regard to the supervision of microfinance, outside the realm of S&Ls. They are conscious of the barriers to access to financial services faced by the great majority of the population (citing reductions in branch networks, high minimum balance requirements for savings deposit accounts and minimum amounts for individual transactions, high thresholds for minimum loans, and requirements for documentation, including photo identity cards, which a majority of the population are unable to satisfy).

While BPNG’s attitude to microfinance is relatively benign, central bank staff feel it is not practical for BPNG to supervise and regulate microfinance. The central bank would probably welcome the creation of some other supervisory and data-gathering mechanism by government. BPNG officials acknowledge that MFIs are operating in an unregulated environment and that even the collection of member savings should, strictly speaking, be regarded as illegal. However, the central bank does not feel responsible for this, although staff make the point that any substantial losses by MFI depositors would call for intervention.

4.2 Developmental Activities for Microfinance

Direct “developmental” activities by the central bank in support of microfinance, such as have occurred in some other countries, have been notably absent in PNG. There has been no central bank lending to MFIs, commercial banks, or apex institutions for microfinance activities. One credit guarantee scheme, the Small Business Guarantee Facility instituted in 1996 by the Small Business Development Corporation, was funded directly from the central government budget with minor involvement of the central bank. Another, the Credit Guarantee Scheme, established in 1996, operates under the sole auspices of the finance ministry. The major commercial banks are “participating financial institutions” in this guarantee scheme. The average approval is around K25,000, and it is directed at indigenous small business rather than micro-enterprise. This guarantee is financed from the budget and does not involve the central bank.

The central bank has not pursued a “developmental” agenda in regard to the financial sector

BPNG has not participated in the capital and management of any MFIs. It has not engaged in or refinanced priority sector lending, the administration of differential interest rates, or other such “developmental” facilities in support of

microfinance. The only current exception to this record of studiously avoiding financially repressive measures is the imposition of a cap on S&L lending rates.

4.3 Promotional Activities for Microfinance

As noted earlier, during the 1960s BPNG's predecessor institution, the Reserve Bank of Australia, saw itself as having a clear promotional role in supporting the monetization of the economy and the creation of a "pre-banking" system of S&Ls throughout the country. In the post-Independence era after 1975, PNGBC actively pursued its mandate of providing financial services to the population by rapidly expanding its outreach through branches and agencies. Whether BPNG should be criticized for having presided over the decline of the S&L movement from the mid-1970s, and over the reduction in commercial bank outreach from the mid-1980s, is difficult to judge. Certainly, it had a host of other demands on it during those years, not least the need to manage a new currency and to assure macroeconomic stability in an extremely open economy vulnerable to commodity price shocks. Clearly, the central bank intends its current push for revitalization of the S&L movement as a measure to counteract the decline in financial institutions' outreach. It has described this as "its most important initiative with respect to rural finance" (BPNG 1998a, 122).

To the extent that savings mobilisation has been a neglected activity in PNG, the central bank must accept some blame. PNG is a high-cost environment for financial services, a disability that applies with particular force to the rural sector. Nonetheless, the considerable potential for savings mobilisation from the subsistence sector, in which the marginal propensity to save from cash income is, in general, higher than the average propensity (Fernando 1991), has not been tapped. BPNG says of itself (1998a, 109) that:

[the central bank] has been cautious in its approach to rural initiatives and has not sought to force the expansion of the financial sector regardless of economic realities. Financial sector policies in rural areas need to be integrated within a comprehensive strategy for rural sector development and expansion will depend upon financial stability, improved infrastructure, growth in agriculture and progress in overcoming the cultural and environmental constraints that perpetuate the country's high cost structure.

The central bank is sympathetic to the possibility that small banks dedicated to serving low income customers can help to fill the gap in access to financial services for the majority of the population. Its negotiation of a financial institutions license for VFL, with an initial capital requirement of K1.0 million, is a promotional initiative to that end. This initiative and the revitalization of S&Ls are positive steps to fill gaps in the country's financial structure.

With regard to S&Ls, legislation in 1995 (discussed in Section 2.3) allowed BPNG to take a firmer grip of the movement and to take "corrective measures" to deal with problems, including "the high rate of loan delinquencies, poor management, inadequate policies and procedures for loans and fund management including the lack of proper internal control system and accounting and book-keeping responsibilities" (BPNG 1998b, 2). BPNG's role in the introduction of a computer software system for S&L accounting from 1995, and its joint funding of a technical assistance project as part of the S&L revitalization and redevelopment program, are other important initiatives.

BPNG is also concerned to correct the pronounced urban bias which had developed in the S&L movement, evident both from the location of remaining active societies and the nature of their lending, which reflected urban consumption patterns with very little lending for agricultural purposes. Under the revitalization program, BPNG working with provincial governments had overseen the creation of five new "regional based" societies by 1998 (BPNG 1998a). Another element in the revitalization

BPNG regards revitalization of S&Ls as its most significant effort to promote rural financial development

The central bank may have failed to give sufficient attention to savings mobilization

BPNG's granting of a financial institutions license to Village Finance and its current support of S&Ls are positive initiatives

BPNG envisages greater involvement with micro-finance in future

program concerned the apex body for S&Ls, the Federation of Savings and Loan Societies. BPNG intends to develop the capacity of the federation “to be actively involved in providing future technical, management and other support services to individual societies” (BPNG 1998b, 8). For that purpose, and also to improve the federation’s financial position and enhance its prestige in the eyes of societies, it was relocated to the central bank building.

As previously mentioned, ADB is preparing a project which would underpin a substantial increase in the level of microfinance activity in PNG, and with which the central bank would be associated. BPNG could thus be in a position to play a leadership role in microfinance development. Matters such as the regulatory implications of innovations in microfinance products and modes of delivery could be given attention by the central bank. BPNG could also accept some responsibility for explaining to the public the need for MFIs and other financial institutions active in microfinance to operate sustainably, and to set interest rates accordingly.

5 Regulation and Supervision of Banks

Approval by BPNG of a small capital financial institution was a positive regulatory initiative

The commercial banks in Papua New Guinea have essentially no involvement in microfinance. They are subject to all the difficulties that impede the engagement of commercial banks with this specialized and costly field (described by Goodwin-Groen [1998]). These difficulties are exacerbated by the high cost of financial operations in PNG, in particular, in rural areas. Such considerations, rather than any aspects of bank regulation as conducted by BPNG, explain their inactivity. Even PNGBC, which has an express public service obligation, has had difficulty in reconciling this with commercial imperatives. This conflict of objectives has become more obvious with the corporatization of PNGBC in preparation for its privatization. Its initiative in creating VFL as a subsidiary financial institution appears to be an effort to address the public service obligations which it feels increasingly unable to meet itself.

While the normal minimum capital level required for a new commercial bank was K5 million, BPNG approved a financial institutions license for VFL with initial capital of only K1 million. Emergency legislation amending the Banking and Financial Institutions Act, in reaction to pyramid schemes, increased the minimum capital level for commercial banks by 200 percent to K15 million in April 2000. Whether a similar increase would apply to the minimum capital required of any other institution wishing to set up in parallel with VFL is not clear. Nor is it clear whether VFL itself will be obliged to increase its capital base further. VFL is not subject to reserve requirements and has less rigorous reporting requirements than the commercial banks. Under its license VFL can, in principle, engage in all domestic banking operations. However, the central bank has imposed an obligation on VFL to target the underprivileged. Further, VFL is required to operate as a not-for-profit entity.

The central bank imposes no interest rate regulations on commercial banks in PNG, nor on VFL. There is no regulatory obstacle to their pricing loans for microfinance clients at cost recovery rates. However, there is no evidence that any of the banks has contemplated doing so to date, and for foreign-owned banks in particular this could pose political risks. Prudential requirements for commercial banks and VFL are, in general, consistent with the Basle guidelines with respect to capital adequacy, loan loss provisioning, and liquidity. Commercial banks are required to maintain a capital adequacy ratio of 8 percent of risk-weighted assets. The central bank has its own “large exposure guidelines.”

Regulatory changes prompted by pyramid scheme abuses may impede future development of small financial institutions

The minimum liquid assets ratio (MLAR) is a further prudential measure, although it doubles as an instrument of monetary policy. There is also a cash reserve requirement, which is separate from and additional to the MLAR. The requirement for

both of these amounted to 25 percent of deposits at June 1999, a considerable brake on bank lending. As mentioned previously, VFL is not subject to either the MLAR or the cash reserve requirement. While the documentation required of retail bank customers increases both borrower and depositor transaction costs, this is not the result of central bank regulation, but rather of requirements imposed by the commercial banks themselves. If PNGBC or any of its rivals were to address the subject of microfinance seriously, there would be a need for BPNG to consider whether any elements in the regulatory environment for commercial bank lending discriminate against microcredit.

The central bank has given increasing attention to supervision requirements and procedures in recent years. Off-site supervision through analysis of statistical returns is the normal mode, but on-site supervision involving inspection of books and accounts and qualitative assessment is also practiced to the limit of staff resources. These resources are fully stretched.

BPNG needs to examine the regulatory framework for commercial banks to find any biases against their engagement in microfinance

6 Regulation and Supervision of Nonbank MFIs

6.1 Regulation of Deposit Taking

In the context of controversy and public disquiet surrounding the activities of unauthorized deposit taking by corporations offering very high returns (described previously as pyramid schemes), the regulation of “bank-like” financial institutions is a sensitive topic. So far as MFIs are concerned, the issue of their deposit taking may become more problematic as a consequence. While BPNG has apparently been content to allow this activity to take place on a small scale among the few MFIs in operation, the need to outlaw deposit taking by pyramid operators may create an unsympathetic environment for MFIs. Amendments to the Banking and Financial Institutions Act, passed in April 2000, broaden the definition of financial activity requiring authorization by the central bank, by making it explicit that the taking of deposits as a business needs either a license or some form of exemption. The Prime Minister, tabling the Bill, said that increased capital requirements would not apply to S&Ls and smaller “genuine” schemes. However, it is not clear whether MFIs such as Liklik Dinau, PnK, and the women’s credit schemes will be caught by the provision for explicit licensing or exemption for deposit taking from their members.

The issue of prudential regulation and supervision of MFIs in relation to their deposit-taking activities has been considered in two recent papers, by Christen and Rosenberg (2000) and McGuire (2000). While there is a consensus that credit-only MFIs do not generally need to be regulated, there is some divergence of views in relation to deposit-taking MFIs. It is generally agreed that those which require some compulsory deposit as a precondition for a loan should not be subject to regulation. With regard to voluntary deposits received from members, Christen and Rosenberg argue that MFIs with levels of such deposits below some agreed threshold should be exempt from regulation and supervision. Also, as a practical matter, it is not feasible in many countries to supervise the large numbers of small MFIs accepting voluntary member savings. Here again, Christen and Rosenberg suggest threshold tests, based on assets, membership numbers, or some other attribute, to select a feasible number of larger operators for supervision and regulation.

However, in regard to institutions that accept deposits from the general public, it is generally accepted that these should be subject to prudential regulation

Regulation of “bank-like” institutions is a sensitive issue, particularly in relation to deposit taking

The central bank may not concern itself with small institutions taking voluntary deposits from members, but deposits from the public are a different matter

Capacity building for MFIs is a more important priority

and supervision. If it is proposed that such regulation and supervision be conducted under the provisions of a special law for MFIs (rather than that they should seek a banking license and be governed by banking legislation) then, according to Christen and Rosenberg, one of the purposes of such a law should be to establish whether MFIs are capable of meeting the full commercial cost of mobilizing savings. This implies that they should be financially self-sustainable, or close to it. Since so few MFIs are in fact in so strong a financial position, McGuire (2000, 8) suggests that “in most countries, strengthening the capacity of MFIs is a higher priority than establishing a special law for MFIs.” BPNG is not disposed to seek the establishment of any such law, and the current practice of the central bank’s ignoring deposit taking by MFIs from members is a sensible one under current circumstances.

6.2 Savings and Loan Societies

The cap on S&L lending rates is an issue of concern, as is the limited capacity of BPNG to supervise these institutions

By contrast, BPNG’s active regulation of S&Ls is of potentially great significance for the promotion of microfinance. The central bank has regulatory authority with respect to interest rates, but allows discretion to the boards of S&Ls with respect to deposit rates. But these are constrained by the 12 percent per annum ceiling on lending rates. The central bank also has authority to review other regulatory provisions that may affect the sustainability of S&Ls, such as loan size limits. The retention of these provisions is anomalous in the light of liberalization of the financial system more generally, and their benefits for S&L members are of dubious value. Prudential regulation for S&Ls is of great importance, as the sorry record of failure in this subsector indicates. However, the limited audit resources of the central bank make it difficult for it to do its job. The 1997 annual report of the registrar of S&Ls (BPNG 1998b) notes that no audit inspections of societies were conducted during 1997 and none was expected to occur during 1998, although visits to two societies per annum were scheduled. Moreover, since the federation of S&Ls is itself undergoing renovation, it may be premature for delegation of some or all of this function to the federation to be considered.

Finally, with respect to other regulated NBFIs, there are finance companies and merchant banks, besides S&Ls. Merchant banks have no relevance for microfinance. Finance companies could previously be established with as little as K0.5 million initial capital but now require at least K1.5 million after the recent legislation. In any case, they primarily serve the corporate sector. The regulation of merchant banks and finance companies by BPNG is not relevant to the promotion of microfinance under present circumstances.

7 Conclusions and Recommendations

7.1 Conclusions

The financial sector in PNG has gone backwards in terms of serving people in rural and regional areas

Financial sector development in Papua New Guinea (PNG) has proceeded slowly. Recognizing the need to achieve greater monetization of the economy and to provide financial services across the country in a relatively simple “pre-banking” mode, the colonial predecessor of the Bank of Papua New Guinea (BPNG) established a savings and loan movement. These savings and loans societies (S&Ls) began to decline in outreach and effectiveness even before the end of the colonial era in the mid-70s. From Independence in 1975 the state commercial bank, the Papua New Guinea Banking Corporation (PNGBC), commenced a drive to expand its branch network

throughout the country, to fulfill the equitable provision of services mandated by its charter. From the mid-1980s, this tide also turned, and the rural and regional population of PNG is now much less well served by the banks than it was at the height of expansion in the mid-1980s.

The financial sector of PNG now includes a small number of quite modern and profitable private commercial banks with very limited outreach beyond major centers. PNGBC has struggled to reconcile its obligation to provide financial services widely with the need to operate profitably in a high-cost environment. While PNGBC does make quite small loans, neither it nor the private banks have ever provided microfinance services in any real sense. The state development bank, Rural Development Bank (RDB), has achieved very limited outreach to its target groups, at considerable cost in terms of operating budget and loan losses.

Since 1992 the central bank has commenced a “revitalization” of S&Ls, regarding them as the key to achieving wider financial services coverage, especially in rural areas. While this is an appropriate policy for rural financial development, it cannot address the problem of providing financial services to the poor, unless S&Ls themselves can be made more inclusive. This is because relatively few S&L members are poor, in the PNG context.

PNGBC is now corporatized in preparation for its eventual privatization, although it still retains its social obligations. PNGBC has established a subsidiary company, Village Finance Ltd (VFL). The central bank has granted VFL a financial institutions license with a mandate to serve the underprivileged as a not-for-profit entity. By establishing VFL, PNGBC may be acknowledging the difficulties it has experienced in serving low income groups.

VFL has commenced operations as a deposit-taking institution for small savers and as a micro-lender, with ambitious plans for expansion. While small, special-purpose banks for small and micro-customers have shown successful results elsewhere, there is no precedent for such operations in PNG and the results of this experiment will be crucial for the prospects of sustainable microfinance in the country. The suggestion that VFL might increase its maximum loan size to K30,000 is not consistent with the institution’s microfinance focus, as mandated by the terms of its banking license.

Microfinance in PNG dates effectively from the late 1980s and performance has been poor for the most part. A small number of microfinance programs are currently in operation, but one microfinance institution (MFI), Liklik Dinau, has been extensively documented. Its experience gives insight into the conditions under which microfinance operates in PNG. Liklik Dinau has been nurtured by government, PNGBC, voluntary agencies, and UNDP, as well as receiving funding from the governments of New Zealand and Australia. Although it is fair to say it has suffered because of uncertainty concerning continuity of funding, Liklik Dinau’s financial performance has been poor. It has been on the brink of insolvency on at least two occasions, being saved only by fresh infusions of capital.

Liklik Dinau’s fieldworkers deal with relatively low numbers of clients, and have high ratios of travel time to client contact. There are also deficiencies in record keeping and accounting, as well as other issues of staff performance and governance. Loans are given in support of a quite limited range of economic activities, and the take-up rate for second and subsequent loans is relatively low. This may reflect the limited scope for informal sector economic activities. Program dropout rates are correspondingly high, and so are arrears. However, Liklik Dinau’s record of savings mobilisation is extremely good. AusAID has committed financial support for another three years to 2002 on a “last chance” basis, tying funding tranches to verifiable performance targets. Further funding will be required beyond 2002 to achieve sustainability.

The central bank is attempting to redress this decline

There is no precedent in PNG for the operation of a small licensed financial institution such as Village Finance

The leading MFI, Liklik Dinau, will require sustained technical assistance but its savings performance is impressive

The growth of unlicensed financial operations in urban areas suggests some gaps exist in service provision by formal institutions

Legislative overreaction to abuses such as pyramid schemes could have unfortunate consequences for legitimate microfinance

BPNG has been mostly judicious in its promotion of financial sector development and has made some positive moves in support of microfinance

In urban areas, professional moneylenders are becoming increasingly active, and the willingness of urban wage earners to pay high interest rates suggests some discontinuities in the range of financial services available from regulated financial institutions, and the failure of those institutions to serve them adequately. The rapid growth of pyramid schemes points to substantial private financial resources being available for investment, but also to limited public understanding of the relationships between investment, rates of return, and risk. While financial scams cause losses to the public in financial systems far more developed than that of PNG, this situation is nonetheless an impediment to financial sector (including microfinance) development. This requires public education and the provision of more appropriate and accessible financial services.

The central bank, BPNG, has not played a marked “developmental” role in regard to economic growth or financial institutions, and certainly not in regard to microfinance. However, it has been judicious in promoting financial sector development and regards its current efforts to revitalize S&Ls as the most significant initiative it has taken to promote rural sector finance to date. It has also responded positively in accommodating the application to establish VFL as a small, low-capital bank of the type which has performed well in microfinance in some other countries. However, its maintenance of a ceiling on the lending rates of S&Ls, which makes their sustainability problematic, is financially repressive and at odds with the interest rate liberalization which prevails for all other financial services.

Central bank staff appear sympathetic but non-interventionist with respect to microfinance. They feel strongly it would not be practical for BPNG to regulate these activities, and while they are aware that some MFIs are mobilizing the savings of members (which is actually illegal), they are prepared to overlook this unless depositors suffer losses. However, the clampdown on pyramid plans has made the issue of unauthorized deposit taking very sensitive and this may have unintended and unfortunate consequences for MFIs. Similarly, increases in minimum initial capital requirements for institutions, which were introduced in response to the pyramid plan crisis, may make the establishment of other “village banks” difficult. It could hinder the development of VFL itself, should further capital injections be required of it.

Overall, however, BPNG’s efforts to revive S&Ls, its encouragement of VFL as an institutional experiment, and its tolerance of MFI savings mobilisation among members are all supportive of efforts to improve access of lower income and rural people to savings services. There is further scope for the central bank to exercise leadership without committing it to a “developmental” role and without causing it to abandon its relatively non-interventionist stance. The formation of a national microfinance network in which the bank could play a nurturing role is one such opportunity.

The preparation of a draft microfinance policy for PNG in March 2000, with the attempt to define the elements of a supportive policy environment and with agreement on potential areas of cooperation between the Government and ADB, offers the prospect of a quantum leap in microfinance activity in PNG. This has implications for a range of financial institutions including the central bank.

7.2 Recommendations

- (1) Development of a comprehensive regulatory environment for MFIs should not be a priority for BPNG at present. Moreover, in light of recent concern about the deposit-taking activities of pyramid plans, BPNG should avoid unintentionally trapping genuine MFIs in any regulatory net designed to prohibit such deposit taking.**

The central bank should continue to overlook the practice of MFIs’ accepting

deposits from members, at least until the time is ripe for a comprehensive examination of the regulatory environment, perhaps in the light of experience with any future expansion of microfinance activity. It would be necessary in the meantime to develop performance standards for MFIs to guide the operations of any future refinance facility.

Comprehensive regulation for MFIs is not an urgent priority

(2) Notwithstanding the previous recommendation, BPNG should contribute actively to the creation of an appropriate policy environment for microfinance.

The draft national policy on microfinance marks a promising start in this respect. While carriage of the policy has been given to the Department of Trade and Industry, it is appropriate for the central bank to take a leading part by reason of its understanding of broader financial market issues and its regulatory responsibilities in the sector.

(3) Within BPNG, the registry of S&Ls should be given a low-key brief to observe the operations of MFIs in PNG, and to become familiar with international experience of microfinance.

This should include field visits to MFIs, which could be arranged in conjunction with visits to S&Ls in the field. The purpose of such observation would be twofold: firstly, by gaining an understanding of the experience of MFIs in PNG, the central bank may be able to apply some lessons learned to improving the operations of S&Ls. Secondly, by gaining familiarity with both international and PNG experience in microfinance, BPNG could become a more informed participant in discussions of the policy and regulatory environment for microfinance with the emergence of a forum or network for microfinance comprising NGOs and other stakeholders.

(4) To encourage the participation of commercial banks in “down-scaling” their operations to encompass microfinance, BPNG should consider whether any elements in the current regulatory regime for banks discriminate against their participation in microcredit.

Consistent with the draft national policy on microfinance, which calls for the “down-scaling” of financial products to meet the needs of a “mass” market, BPNG should examine whether the current regulatory regime has any implicit biases against microfinance.

BPNG should contribute to a supportive national policy environment for microfinance

(5) With respect to regulated financial institutions engaging in microfinance, including S&Ls and Village Finance Ltd, BPNG should avoid imposing higher capital requirements upon them in the wake of the pyramid plan episode.

These institutions, which are dedicated to serving the poor and rural people, should not be hampered in achieving that goal by unnecessary minimum capital requirements. Nor should any other institution seeking a financial institutions license similar to that granted to VFL be penalized by a higher minimum capital requirement, if it is otherwise qualified for licensing.

(6) BPNG’s revitalization of S&Ls appears to be an appropriate response to the dearth of financial services available to lower income and rural people in PNG. Further judicious expansion of S&Ls may be appropriate, including expansion in rural areas as far as possible, as well as efforts to make all S&Ls more inclusive.

However, in the absence of data tracking the performance of S&Ls against performance criteria over the period of the revitalization campaign, it is difficult to be too prescriptive here. BPNG should consider publishing data in the annual report of the S&L movement to enable a more informed judgment of performance for the subsector as a whole, as well as monitoring the extent to which the movement is expanding membership to encompass lower income groups and women.

The registry of S&Ls should take a positive interest in microfinance of all kinds

S&Ls should have more flexibility to set deposit and lending rates

BPNG has a public education role in the interests of financial development

(7) BPNG should also consider allowing greater flexibility in interest rates for S&Ls. Higher lending rates would permit higher margins and/or higher deposit rates.

Higher margins would make the sustainability of S&Ls less problematic; higher deposit rates would tend to increase the sense of proprietorship of the majority of members who are infrequent or non-borrowers, with beneficial effects on governance of S&Ls, which has been a problem in the past. Higher deposit rates might also encourage an expansion of the membership of S&Ls to lower income groups, making them more inclusive.

(8) The pyramid plan episode indicates that substantial public education in financial matters is needed, and the central bank could contribute to such educational processes.

While BPNG cannot be solely responsible for such a task of education, it could take a leadership role. The governor of a modern central bank has a public platform for messages of importance, and an aware and alert media can be a powerful means of disseminating them.

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