2016 Annual Banking Industry Report

FINANCIAL INSTITUTIONS COMMISSION
of the
REPUBLIC OF PALAU

This report is provided pursuant to § 1016 of 26 PNC Chapter 10, the Financial Institutions Act.

G. Semdiu Decherong
Executive Commissioner

May 29, 2017
Date

2016 Annual Palau Banking Sector Report

Summary Industry Assessment

The overall condition of the Palau banking sector remains satisfactory and there continues to be growth and stability. Assets grew 14% during the year as a result of continued expansion in customer deposits. Aggregate capital for the two remaining locally chartered banks grew 1.9% in 2016 due to net profit growth. Uninsured locally chartered banks demonstrate the desire to maintain capital growth although the rate of capital growth has diminished compared to the prior year. The slowdown in the sector's expansion is correlated with decline in economic activity, particularly in tourism due to the effects of the drought experienced last year as well as the termination of charter flights.

Asset quality indicators remain satisfactory. Overall, the ratio of Non Performing Loans (NPLs) to Total Loans fell from 2.10% to 0.78% during the year. Loan volume slightly increased by 1.7% or approximately $496M and Provisions for Bad Loans remain adequate to mitigate against potential losses, at six times the sector's volume of Non-Performing Loans.

Return on Assets increased from 1.38% to 1.50% due to improvements in earnings. Relative stability is maintained as a result of asset growth. Also contributing to stable profits for the banking sector, the decline in Non-Interest Expense to Average Assets from 1.14% to 1.01% suggests that local banks have managed to keep costs down notwithstanding continued asset growth. At the same time, the decrease in Provisions for Loss Expense to Average Assets is correlated with decline in NPLs mainly in response to FIC recommendations during onsite examinations. Severely delinquent non-performing assets maintained on the balance sheets of certain institutions have been adequately resolved or charged-off, and thus, resources are more effectively utilized, earnings has improved, and performance more accurately reflected in reported figures.

Liquidity remains adequate and all banks demonstrate the ability to continue to meet depositors demand. Funds management practices are adequate for the scope of local banking operations, as supported by onsite exam findings, and continue to demonstrate satisfactory results. U.S. branches continue to generate strong earnings from excess funds invested abroad, and maintain reliable access to adequate sources of funds to meet anticipated local liquidity needs.

*[Note: for the purposes of this report, numbers accompanied by the Roman numeral "**M**" represent figures in thousands, and "**MM**" represents figures in millions]*

New Developments

Governing Board of Commissioners

There remains one vacant seat on the FIC Governing Board of Commissioners that has yet to be filled. Mr. Fabian Iyar was nominated and appointed to the Board by the President but did not garner enough votes from the Senate in February 2016 to be confirmed. Mr. Tutii Chilton was reappointed and confirmed to the Governing Board for another three-year term and remains the Chairman of the FIC Board. In terms of governance, the FIC Governing Board amended its by-laws and adopted revisions to the Board's compensation clause, as well as the regular

session schedule and agenda. Regular sessions of the Governing Board take place every second Wednesday of each month, 10a.m., at the FIC Office, and are open to the public.

New Banking License

During the 2016 calendar year, the Commission received two application packets for new banking licenses. One involved the acquisition of an existing locally chartered bank and the other for a proposed new bank. The Governing Board of the FIC had lifted the moratorium on issuance of new banking licenses by that resolution unanimously adopted on and dated July 29, 2010. The moratorium on the establishment of new banks in Palau became effective on February 19, 2003 by FIC Resolution No. 02-2003-03 dated the same in order to allow the Commission time to adopt and fully implement its prudential and administrative regulations as promulgated under the Financial Institutions Act. The two applications received in 2016 were the first to be submitted following the Board's lifting of the moratorium. During the year, there was also one other inquiry into obtaining a banking license and potential investors had met with the FIC Commissioner and Board, although the FIC did not receive an application pertaining thereto. As calendar year-end 2016, the FIC was still conducting routine correspondence and getting additional information on both applications.

National Development Bank of Palau

The Executive Commissioner and Bank Examiner met with the NDBP Board and Management in February 2016 to discuss the Report of Examination, which laid out the findings and recommendations from the FIC's onsite examination of the development bank during November 2015. The Executive Commissioner also discussed the examination findings, particularly in relation to capital and related accounting treatment, with the NDBP auditor, an agent of Deloitte & Touche Mr. Karvin Flynn during the year to reconcile some of the differences between government accounting and financial reporting standards. The FIC, in support of NDBP's legislated role to take deposits, worked with the Asia Development Bank to retain expert Technical Assistance from the ADB to help the bank to ensure that it can and will be ready to take deposits.

Cooperation & Collaboration with International Organizations, Agencies, and Financial Institutions

IMF, PFTAC and the AFSPC

The FIC met with the IMF Article IV Mission review team on May 23rd. The outcome of the consultation was a positive assessment of Palau's financial sector oversight and the FIC's regulatory regime.

In June 2016, Palau hosted the Association of Financial Supervisors of Pacific Countries' (AFSPC) annual meeting. The FIC has been a member of the AFSPC since 2003. The annual meeting of the AFSPC has never been held in any of the North Pacific countries until 2016, where Palau was the first country in the North Pacific to host such an event. The meeting was held at the Palau International Coral Reef Center (PICRC) from June 13th through June 17th with twenty participants from ten Pacific Island countries in attendance.

U.S. Secret Service

The FIU and FIC collaborated with the U.S. Secret Service in the capture and confiscation of counterfeit currency. Two cases in particular garnered the attention of the media involving Jordanian and Syrian nationals attempting to circulate counterfeit U.S. bills in the country. On October 20-21, 2016, the FIU held a training workshop conducted by the U.S. Secret Service (USSS) on counterfeit currency and card skimming. The training sessions were very well attended by the private sector and law enforcement agencies. The FIU, Division of Customs, and the Criminal Investigation Division (CID) were presented with plaques from the USSS for outstanding assistance and support on behalf of the investigative responsibilities of the United States Secret Service.

Financial Intelligence Unit (FIU)

FIU Director Nelson Werner's contract was renewed for another two years ending on January 31, 2018. The FIU Director passed the Palau bar exam and, in addition to his administering role at the FIU, effectively became legal counsel for the FIC.

The FIU database was developed with assistance from two IT graduate students from Carnegie Mellon University. Following the launch of the database, electronic online filing of CTRs and STRs commenced during the year. Now all licensed banks in Palau have the capability to file these critical reports electronically through a secure portal online. This has greatly enhanced and made efficient the work of generating reports and analyzing data.

Two Governing Board members and the FIU Analyst attended the training on implementing AML/CFT frameworks at the IMF's Singapore Training Institute. The FIU Director attended an intensive APG Assessor's Training in Macau in June 2016 in preparation for the upcoming 3rd Round Mutual Evaluation of Palau set to commence in late 2017. Additional training received during the year include a workshop on Designated Non-Financial Businesses (DNFBs) held in Korea. The Korea FIU funded both the FIU Director and FIU Analyst's travel to attend the workshop.

Other training held in Palau include a workshop on illicit finance and terrorism financing facilitated by the Organization of American States.

Following a U.S. IRS training held during the first half of the year, the FIU created the Financial Crimes Investigation Unit modeled after the U.S. IRS system. This is in tandem with the work being done with the Money Laundering Working Group which held several meetings throughout the year. Cooperation among agencies and the FIU analysis of reports resulted in the dissemination of suspicious transactions reports related to drug trafficking and money laundering cases. This type of collaboration among stakeholders is imperative in achieving the success envisioned by the FIU Director, who has always emphasized that the FIU collects intelligence, performs analysis, and coordinates work with law enforcement so that financial crimes including money laundering may ultimately be investigated by the appropriate authorities and prosecuted by the Attorney General's office.

The FIU started work on a National Risk Assessment (NRA), a process involving identifying areas of vulnerability to money laundering and terrorism financing in the country. A questionnaire was disseminated including comprehensive guide for the NRA, both developed by the FIU to collect data from relevant agencies such as Customs, Immigration, Tax & Revenue, Foreign Investment Board, etc. An NRA has never been done for the country and the FIU initiative is an advancement of the requisite information needed for the upcoming Mutual Evaluation by the Asia Pacific Group on money laundering (APG).

Legislation & Regulations

The FIC and FIU requested additional funding and respective line items were included in the supplemental budget request put through the *Olbiil Er a Kelulau* (national congress) during the year. Pending legislation that raised concerns with the FIC Board include the proposed corporations act and the credit union act, among others. ADB's Terry Reid and Anthony Frazier made several visits to Palau and held meetings with the FIC and other stakeholders to discuss plans to move forward with the Corporate Registry Act, the draft of which was completed in October.

Chairman Chilton and the Executive Commissioner attended the Senate hearing in May regarding the Land Court deadline. The Executive Commissioner provided comments on the proposed legislation's potential impacts on mortgage lending practices. Other proposed legislation that the FIC provided comments on in 2016 included the proposed amendments to the foreign investment legislation and the bankruptcy bill.

The FIU drafted proposed regulations for Designated Non-Financial Businesses or Professions (DNFBPs). Other proposed regulations pending review and approval are Alternative Money Remitters' Licensing regulations and Customer Due Diligence regulations.

Background & General Overview

The Financial Institutions Commission (the Commission or FIC) is responsible for the licensing, supervision, and regulation of all banks and financial institutions in the Republic of Palau. The Commission was established as an independent and autonomous agency by Republic of Palau Public Law No. 6-3, commonly known as the Financial Institutions Act of 2001 (FIA or the Act); the Act was further amended and improved during the 7th Olbiil Era Kelulau under Republic of Palau Public Law 7-41. The FIA was codified into the Penal Code under 26 PNCA Chapter 10.

Structure of the Commission

The Commission is governed by a **Board of Commissioners** (**Governing Board**). The Governing Board functions as a policymaking body to promulgate the rules and regulations by which the Commission operates. The Governing Board also oversees the enforcement of policies, rules, and regulations as they apply to all licensed banks. The Governing Board is composed of five voting members and an Ex-Officio member. The five voting members are appointed by the President of the Republic of Palau, subject to the confirmation of the Senate and serve staggered two and three year terms; the sixth Ex-Officio member is the President of the National Development Bank of Palau (NDBP), as mandated by law.

The **Executive Commissioner** manages and oversees administrative tasks and operational matters of the Commission. The Executive Commissioner is responsible for the implementation of Governing Board policies and ensures bank compliance with FIC Regulations and executes Governing Board approved enforcement actions. Policy initiatives, in particular those that pertain to the monitoring and regulation of the Republic of Palau banking sector, are recommended by the Executive Commissioner to the Governing Board. The Executive Commissioner is appointed by and answers directly to the Governing Board and serves as the "Examiner in Charge", which involves the tasks of conducting and managing on-site examinations and is responsible for determining the scope and type of exams for banks in noncompliance with laws and regulations. All bank examinations conducted by the Commission are subject to final approval by the Examiner in Charge.

The **Bank Examiner** answers directly to the Executive Commissioner and is primarily responsible for conducting off-site analysis and on-site bank examinations. These include but are not limited to quarterly and annual analyses of individual bank and sector-wide financial returns, as required by FIC Regulations, and any available financial sector statistics. Off-site examinations involve the review, analysis, and detection of trends and/or singular events that may impact banks' financial condition. This off-site monitoring of financial institutions is conducted quarterly or as needed to the Executive Commissioner for determination of proper supervisory actions.

On-site examinations involve visits to bank/branch offices by the Executive Commissioner and Bank Examiner for an in-depth and detailed review of bank documents, records, as well as general observations of bank operations, for the purpose of assessing six bank rating components (i.e. Capital adequacy, Assets quality, Management, Earnings, Liquidity, and Sensitivity to market risks). Such exams are mandated in the Act, and are conducted in order to regularly monitor the performance of banks to ensure the soundness and stability of the overall sector. On-site bank examinations allow for the Commission to assign an overall rating for individual banks, which allows for the appropriate levels of supervisory actions and regulatory oversight to ensure the safety and soundness of individual banks.

The **Office Manager (Administrative Officer III)** manages the administrative operations of the FIC office with oversight by the Executive Commissioner and is responsible for the maintenance of records, documentation processing, and fulfills all clerical and related operational and administrative functions. The Office Manager is responsible for preparation of annual budgets and assists in the monthly reporting to the Governing Board of fiscal performance of the agency. The Office Manager ensures proper procedures are followed in the procurement of goods and services and monitors operational expenses to ensure adherence to the Governing Board approved budget and works directly with the Executive Commissioner to ensure that internal fiscal policies or guidelines are adhered to and agency expenses are kept at a minimum. In addition to administrative tasks, the Office Manager is also the Registrar of the Secured Transactions Registry.

From July to August 2016, the FIC developed an internship program and hired an **Intern** for the first time through a collaborative arrangement with the Palau National Scholarship Board. Ms. Isola E. Solang joined the FIC and

FIU team for eight weeks during her summer break from university in Taiwan. She assisted both the FIC and the FIU in administrative tasks and learned to draft and generate analysis reports for the financial sector.

Anti-Money Laundering

In addition to regular bank supervision, the Commission is given authority in the Financial Institutions Act to examine all financial institutions' Anti-Money Laundering and Counter Financing of Terrorism (AMLCFT) procedures and reporting standards. Such examinations may, at the sole discretion of the FIC, be conducted as an on-site or off-site examination, or both. The FIC includes onsite AML/CFT examinations during regularly scheduled onsite bank examinations.

Financial Intelligence Unit

The Financial Intelligence Unit (FIU), established by 17 PNCA Chapter 38, is located within the FIC and operates as an independent body with a separate operating budget provided by national government. The FIU is overseen by the Governing Board of the FIC. Mr. Nelson Werner, an American Attorney formerly with the Office of Independent Counsel and the Palau Attorney General's Office remains the FIU Director and has been Head of the FIU since passage of legislation in 2014.

Internal and External Cooperation

In the interest of maintaining the reputation of the Republic of Palau in the international financial community, the Commission is authorized by the Act to cooperate and exchange information with agencies of foreign governments and international organizations. To this extent, Section 8 of the Act stipulates that a grant of a banking license by the Commission constitutes consent of the financial institution to release to and exchange information with any law enforcement, regulatory, or supervisory authorities of any foreign government in which the financial institution operates or conducts business. As such, the Commission has worked with the U.S. Federal Deposit Insurance Corporation (FDIC), Australian Prudential Regulatory Authority (APRA), Bank Negara (Malaysia), Banco Central (Philippines), ROC Taiwan Financial Services Commission, Hawaii State Division of Financial Institutions, FSM Banking Commission, RMI Bank Commission, and other foreign regulatory authorities on a myriad of issues concerning both foreign regulators and the Commission. The Commission cooperates with competent authorities outside Palau and with international organizations in terms of its collection of statistics and related financial sector information for the purposes of comparative analysis and compliance with international regulatory and reporting standards. It is further mandated in the Act that the Commission cooperate with local public authorities in pursuing its objectives.

Training and Technical Assistance

The Commission receives extensive technical training and support from international organizations and supervisory agencies such as the International Monetary Fund (IMF), the Pacific Financial Technical Assistance Centre (PFTAC), and recently, the U.S. FDIC. The Executive Commissioner and Bank Examiner have successfully completed the first three phases of the FDIC's series of examination schools. The FIC Bank Examiner completed the final part of FDIC examination training in November 2016, which was made possible through a grant awarded to the FIC by the U.S. Department of Interior for the purpose of technical capacity building. The Bank Examiner is currently the only banking regulator in the Pacific who holds the distinction of having successfully completed the U.S. FDIC's Examination Management School, a requisite for earning the distinguished Commissioned Examiner status in the United States.

Other training received by the Executive Commissioner includes areas such as designing effective legal frameworks for problem bank supervision, Anti-Money Laundering and Counter-Terrorist Financing, FDIC Receivership methods, and others. In addition, the Bank Examiner has received training on liquidity frameworks and analysis, loan and financial statement analysis from PFTAC in conjunction with APRA and the Bank of International Settlements' Financial Stability Institute, and training on the implementation of AML/CFT regulatory frameworks from the IMF's Singapore Training Institute.

Sector Overview

The Financial Institutions Commission monitored and regulated five banks during the 2016 calendar year—three U.S. bank branches and two locally chartered banks. The three foreign bank branches are U.S. chartered and insured by the U.S. Federal Deposit Insurance Corporation (FDIC) whereas the locally chartered banks do not maintain depositor insurance. The National Development Bank of Palau, formerly exempt from regulation and oversight, automatically fell under the supervisory authority of the FIC when RPPL 9-41 was signed into law on

December 5, 2014. However, the NDBP will not be subject to the FIC's regulatory regime until the bank is formally licensed.

For the purposes of this report, the banking sector has been divided into two banking groups, namely the insured banks and uninsured banks, due to the broad differences in size and business scope that are unique to the banks that have been categorized within these groupings. Statistics for the National Development Bank of Palau are not yet incorporated into the FIC's Annual Report to the OEK and will be excluded from aggregate industry data for the banking sector until the NDBP is issued a banking license.

In this report, "insured banks" means those banks/branches whose deposits are insured by the U.S. FDIC; and "uninsured banks" are those banks that do not maintain depositor insurance under a government sponsored insurance program. As of the calendar year ended December 31, 2016, the U.S. bank branches hold approximately 93% of the banking sector's aggregate Net Loans and 99.8% of the sector's aggregate Total Deposits. [1]

The Commission's primary objective is to ensure the liquidity and solvency of banks in the Republic of Palau pursuant to the requirements of the Financial Institutions Act and regulations promulgated therein. The agency fulfills its objective by conducting offsite monitoring of all licensed banks and through onsite examinations.

Off-Site Monitoring and Bank Examinations

The Commission schedules onsite bank examinations based on each bank's assigned rating determined at the most recent onsite examination in accordance to a Regulatory Response Policy. The Executive Commissioner reviews quarterly an individual bank's financial information reported on the FIC Prudential Returns as well as analysis reports produced by the Bank Examiner. Quarterly returns consist of three forms and several related schedules providing current information on an institution's balance sheet and income and expense statements.[2] Quarterly prudential returns and analysis reports are the main component of the FIC's off-site monitoring program and the Commission utilizes quarterly assessment reports as an integral part of on-site bank examination planning and scheduling.

Data submitted by all licensed banks on quarterly prudential returns are entered into a computer database and used in the calculation of pertinent ratios and indicators which help to monitor the performance of each bank. These ratios and indicators are compiled into a report aptly named the Uniform Bank Performance Reports which are disseminated as appropriate to all licensed banks. The UBPRs contribute to the FIC's off-site monitoring program and provide comparative analysis and performance tracking for each bank, banking group, and industry wide. Valuable data is provided to management of each licensed institution through dissemination of UBPRs and the publication of quarterly and annual reports on the FIC's official website.

The FIC continues to regularly and consistently produce timely analysis reports for each licensed bank and branches, as well as an overall banking industry report every quarter. These reports are produced by the Bank Examiner and submitted to the Executive Commissioner for review and final draft. The industry report is generated as a general overview of the condition of the banking sector and is submitted to the Governing Board of the FIC. An annual report is also produced for submission to the Olbiil Era Kelulau (OEK) as required under the banking law using figures from those statements of condition published annually by each licensed bank in Palau as well as aggregate figures derived from the FIC's quarterly prudential returns. This report is the eighth annual report published by the FIC. The seventh Annual Banking Sector Report was submitted to the OEK (Palau National Congress) on March 11, 2016, for the calendar year ended December 31, 2015; the sixth Annual Banking Sector Report to the OEK was submitted on May 4th, 2015 for the calendar year ended December 31, 2014; the

[1] Historical data indicates that U.S. branch institutions continue to lead the sector in assets and deposits and are reporting fairly consistent growth and stable to growing market share. As a cautionary note, published figures and those reported to the FIC may differ due to variations in reporting requirements from bank accounting procedures.

[2] Previous regulatory financial forms were submitted on a voluntary basis by banking institutions until September 1, 2008 when FIC Prudential Regulations were made effective and required regular quarterly reporting from all licensed banks. The FIC prudential forms were revised in January 2009 and again in July 2012 to include more detailed breakdowns of financial statement items. The required forms were initially implemented beginning December 2009 and all banks in the sector are required to submit all relevant forms and schedules, certified by bank officials, in electronic form within 30 days following each quarter-end.

fifth was submitted on April 15th, 2014, for the calendar year ended December 31st, 2013. Prior year reports submitted to the OEK are available through the FIC official website.

The FIC conducted a total of four onsite examinations during the 2016 calendar year. Examinations were conducted on Palau Construction Bank, Bank of Hawaii, and Asia Pacific Commercial Bank. One bank was examined twice within the year to follow up on ongoing matters.

Onsite examinations are scheduled based on composite ratings issued using the CAMELS rating system adopted from the bank examination procedures employed by U.S. regulators. Both the Executive Commissioner and the Bank Examiner have completed several bank examination trainings by the U.S. FDIC and PFTAC. In fact, the Bank Examiner has successfully completed the U.S. FDIC's Examination Management School, a requisite feat to earn the Commissioned Examiner status for U.S. bank examiners, and is currently the only examiner in the Pacific who holds this distinction.

The FIC has established amiable and productive working relationships with designated reporting officials for the three U.S. branch institutions and the Boards and Management of all other banking institutions in Palau. The Commission continues its efforts to improve the quality of information reported by fostering better communication between the agency, bank/branch managers, and related officials that play a pivotal role in ensuring adequacy and accuracy in financial reporting and compliance with regulatory requirements.

Agency Interaction and Cooperation with Regulated Banks

All licensed banks have cooperated with the FIC in compliance with Prudential Regulations and have lent their cooperation and support to this agency's efforts in statistical data collections, prudential reporting, onsite bank examinations, and other issues. The FIC intends to continue to foster the existing good working relationship with all licensed banks to ensure cooperation, assistance, and input on regulations, the banking law, compliance issues, and other matters pertinent to the industry.

The FIC maintains open and transparent communications with all regulated banks and ensures that these industry partners are informed on matters affecting their operations, i.e. bank examinations, off-site reviews, revisions of laws and or regulations, policy initiatives, and fee assessments.

Financial Institutions Not Regulated by the FIC

Insurance providers/agencies, micro-lending facilities (a.k.a. finance companies), pension funds, and credit unions with assets less than $500,000 are exempt from regulatory oversight and supervision. However, the FIC has received expert advice and opinions from the Asian Development Bank, the IMF, and PFTAC regarding bringing these non-banks under its supervisory authority.

Below is an analysis of the current condition of the banking industry. On September 1st, 2008, Prudential Regulation PR-03 became effective and established requirements for all banks and branches of foreign banks (banks) to prepare and submit quarterly reports to the FIC within 30 (thirty) days following each quarter ending on March 31st, June 30th, September 30th, and December 31st of every year. Figures are required to be reported on a calendar year-to-date basis in accordance with written instructions prepared and issued by the FIC. Aggregate figures used in this report are derived from these quarterly prudential forms submitted to the Commission.

BANKING SECTOR INDICATORS: Capital, Assets, Earnings, & Liquidity

[Note: for the purposes of this report, numbers accompanied by the Roman numeral "**M**" represent figures in thousands, and "**MM**" represents figures in millions]

CAPITAL ADEQUACY (Uninsured banks):

- **Aggregate capital for uninsured banking institutions continues its upward trend and increased by 1.9%, or $62M, during the year.** The consistent earnings performance of one of the two locally chartered banks has resulted in aggregate capital accretion for the uninsured banks, which individually are required to maintain at least one million U.S. dollars in capital.
- The FIC monitors Uninsured banks to ensure capital levels are maintained above statutory minimum requirements and has verified each bank's capital position during onsite examinations conducted during the 2015 and 2016 calendar years. As of the calendar year ended December 31, 2016, the two uninsured banks in the sector remain in compliance with regulatory minimum capital ratios pursuant to statute and FIC prudential regulation PR-01 as well as the required minimum level of capital.

ASSET QUALITY:

- **Quality of assets remains satisfactory for the banking sector**.
  The quality of the sector's loan portfolio continues to be satisfactory**.** The ratio of Non Performing Loans to Total Loans declined from 2.10% at the prior year down to a nominal 0.78%. The total volume of Non Performing Loans (NPLs) fell 63%, or by $412M during 2016. The volume of NPLs at calendar year-end 2016 is approximately $245M relative to the $31,563M in aggregate loans for the banking sector.
- Total loans slightly grew by 1.7%, or $496M, during 2016. Unsecured consumer loans, which comprise 93% of the sector's portfolio, grew 2.1%, or by approximately $615M and Business loans (i.e. loans to Non-financial corporations) slightly rose by $10M or 0.8%. The volume of secured loans continues to decline, and dropped by 12% or $322M during the year, despite the Secured Transactions Registry having been established for some time now.
  - *Insured U.S. banks* hold 98%, or approximately $277MM, of the banking sector's total assets of $283MM; 91% or approximately $29MM of the sector's total loans; and 78%, or approximately $192M of the sector's Non Performing Loans as of year-end.[3]
- **Provisions for Bad Loans remain adequate for all commercial banks**. Aggregate Provisions for Bad Loans exceeds the sector's volume of Non Performing Loans six times over, indicating that there is sufficient cushioning that well exceeds the potential for loan losses and the FIC regulations.
- Due From Home Office balances of U.S. Branches comprise 86% of the banking sector's Total Assets. Approximately $244MM of the industry's $247MM in Liquid assets are demand deposits due from the Home Offices of U.S. FDIC-insured banks. Onsite exam findings show that most of the **Insured bank branches generated yields higher than the average effective Federal Funds Rate**.

EARNINGS PERFORMANCE:

- **Earnings performance for the sector continues to be satisfactory.** Most banks generated profits during the calendar year. Stable profitability is expected overall as lending has the potential to expand supported by excess liquidity.
  - Return on Assets (ROA) for the overall sector has increased from 1.38% to 1.50% during 2016. According to the most recent interest rate surveys conducted, deposit rates range from 0.01% to 2% with local savings and time deposit rates stable. Lending rates remain capped at 18% due to standing legislation although variable rates have remained relatively unchanged and range between one and three percent above the Prime rate. Unsecured consumer loan fixed

[3] The FIC has confirmed during onsite examinations of these branch institutions that internal policies and procedures, particularly those that dictate asset management, comply with prudential regulations, ensuring that asset quality remains satisfactory and resulting in minimal losses as demonstrated by historical figures reported for this group of banks.

rates range from 11% at the lowest, whereas business loans may yield as low as 7.25% depending on subjective criteria specific to each bank's credit policy.

- Net Interest Margin (NIM)[4] is slightly lower compared to last year. NIM fell from 2.56% to 2.38%. On the other hand, Yield on Loans has slightly increased from 10.91% to 10.97% compared to prior year-end, suggesting that the rate of growth in earning assets outpaced the rate of growth in asset yields. Although loan rates remained relatively unchanged, yield on excess liquidity placed abroad significantly increased overall.
- The estimated average yield on aggregate balances Due from Home Office & Other branches of the *Insured group of banks* has increased from 0.87% last year-end to 1.11%. The average yields of U.S. bank branches operating in Palau have historically been above the Effective Federal Funds Rate. The average Effective Federal Funds Rate for 2016 was 0.40%. The yield on local branch balances maintained at U.S. bank Home Offices indicate strong earnings from the investment of excess funds outside Palau.

Condensed Income & Expense Statement

Annualized (in U.S. '000s)	CYE2015			CYE2016		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Interest And Fee Income	5,189	515	5,704	5,958	547	6,505
Interest Expense	160	1	161	198	1	199
NET INTEREST INCOME	**5,029**	**514**	**5,543**	**5,760**	**546**	**6,306**
Provisions For Bad Loans Expense	**624**	**70**	**694**	**247**	**24**	**271**
NON-INTEREST INCOME	**870**	**6**	**876**	**927**	**6**	**933**
NON-INTEREST EXPENSE	**2,167**	**369**	**2,536**	**2,304**	**438**	**2,742**
NET INCOME (LOSS) BEFORE TAXES	3,108	81	3,189	4,136	90	4,226
Less: Applicable Income Taxes	113	10	123	143	11	154
Year-to-date Income (Loss)	**2,995**	**71**	**3,066**	**3,993**	**79**	**4,072**

LIQUIDITY ADEQUACY:

- **Liquidity continues to be strong for all banks in the sector.**
- The Liquidity Ratio calculated for the banking sector, at 92%, continues to be stable and growing. This means that for every dollar in short term liabilities, the banking sector maintained 92 cents in liquid assets. Liquid assets[5] grew by approximately $34MM, or 16% during 2016, which is commensurate with the increase in short term deposits.
- Even though local liquid assets (i.e. cash balances) aggregated for *Insured branch institutions* cover just 0.75% of total short term liabilities, including deposits with maturities of one year or less for this group of banks, onsite examinations of all U.S. branch institutions show that insured branches maintain sufficient funds to meet depositor demands and operational needs. All U.S. branches demonstrate a net cash export position as well as maintain adequate reporting and monitoring systems to manage risk of cash shortfall.
- Notwithstanding concerns with the security of their respective liquid assets, *Uninsured banks* demonstrate ability to cover all customer deposits and short term liabilities and rely more on capital to generate earnings.
- **All banks in the sector demonstrate continued ability to meet depositor demands**.

[4] Net Interest Margin is equal to Net Interest Income, which is the difference between Interest Income and Interest Expense, divided by Average Earning Assets. Earning Assets comprises net loans and deposits placed with the headquarters of local branches which earn a return from investments abroad. NIM will generally be lower than the difference between average yield on loans and cost of deposits because it is a calculation of the estimated return for every dollar of earning assets.

[5] Liquid Assets (PR-10) includes (i) currency and coin, domestic and foreign, to the extent that any foreign currency is readily convertible to U.S. dollars; (ii) net balances with banks, domestic or abroad, to the extent that such balances are not encumbered or subject to withdrawal restrictions and have a remaining term to maturity of one year or less; and (iii) unrestricted, readily marketable securities which have a value that can be determined from a listing on a recognized international securities exchange.

- Total Deposits for the banking sector grew 14%, or by approximately $34MM, during the calendar year and totaled approximately $272MM at the most recent year-end. The deposits of national government and non-financial corporations led deposit growth, having experienced $9.3MM (or 34%) and $9MM (or 8%), respectively, during the year. The deposits of Individuals and Development Financing Corporations follow suit expanding by $8MM (or 12%) and $5MM, respectively, during 2016. Similarly, State government deposits grew 12%, or by approximately $3MM.
- The ratio of Total Deposits to Total Loans increased from 761% to 861%, commensurate with deposit growth outpacing loan growth. This ratio means that on average, for every dollar in loans, the sector maintains approximately $8.61 in deposits. This ratio has several implications, including that deposits continue to be taken in faster than new loans are being issued by banks in the sector. Although bank officials have expressed during onsite exams the willingness and capacity to expand their respective loan portfolios, there are factors inhibiting any significant growth in loans. Namely, lack of legislative support for real estate secured lending and market size (i.e. limited pool of qualified borrowers). Rather than investing locally in terms of expansion in lending activities, U.S. banks continue to invest excess liquidity abroad.

OTHER BANKING SECTOR STATISTICS

Remittances (*U.S. bank branches are the only local financial institutions with wire transfer capabilities*)

Palau maintains a net outbound position in remitted funds, meaning more funds are sent outside Palau than are received by local institutions.

- **A total of approximately $134MM came into Palau and approximately $138MM was sent abroad during the 2016 calendar year** through the local banking sector. Remittances to and from the U.S., Taiwan, and Japan – our main trading partners – top the list.
- Remittances received in Palau from those three above listed countries together comprise 79%, or approximately $105MM, of total funds received during 2016. Of the total Outgoing wire transfers during 2016, approximately $85MM in funds, or 62%, were sent to those same three countries listed above. Another $14.4MM was sent via wire transactions to the Philippines during the year.
- National government received approximately $9MM, or 25%, more in funds compared to the previous year. The domestic Private Sector (non-financial corporations, individuals, and non-profit institutions), received approximately $90MM and sent out $126MM via wire transfers during the 2016 calendar year.

Financial Access

The number of Depositors and number of Borrowers are aggregated from figures reported by all five banks, and as such, there will be overlap as there are customers that will have accounts at multiple banks.

- The sum of the number of Depositors reported by all licensed banks declined compared to the prior year, despite further expansion in the sector's volume of funds held in deposit accounts and slight increase in the sum of the total number of deposit accounts reported. The aggregate total number of Depositors was reduced from 19,919 down to 19,761. The average number of depositors for the banking sector, if every depositor held at least one deposit account at three of the five licensed financial institutions, is 6,587—down from 6,640 last year. The total number of Deposit Accounts slightly increased from 22,155 to 22,176—an increase of 21 deposit accounts.
- The total number of Borrowers declined from 6,272 to 5,810 whereas Loan Accounts increased from 6,265 to 6,354 during the 2016 calendar year. This implies a gradual expansion in local access to credit, particularly the opening up of credit facilities for borrowers with established credit records and good credit performance. Notwithstanding the establishment of a Secured Transactions Registry, the volume of secured loans continues to decline. Secured loans declined by 12%, or $322M during the 2016 calendar year.

Ratios & Summary Balance Sheet

KEY RATIOS (%)	CYE2015			CYE2016		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Total Capital to Total Assets	n.a.	55.60	n.a.	n.a.	55.84	n.a.
Tier 1 Leverage Capital Ratio	n.a.	54.37	n.a.	n.a.	54.48	n.a.
Tier 1 Risk Based Capital Ratio	n.a.	87.11	n.a.	n.a.	87.61	n.a.
Total Risk Based Capital Ratio	n.a.	90.59	n.a.	n.a.	91.29	n.a.
Non Performing Loans to Total Loans	1.76	5.42	2.10	0.67	1.85	0.78
Provisions for Bad Loans to NPLs	192.61	505.13	266.82	406.77	1,450.94	632.65
Net Income to Average Assets (ROA)	1.38	1.21	1.38	1.50	1.36	1.50
Net Int Inc to Avg Earning Assets (NIM)	2.37	13.30	2.56	2.20	14.40	2.38
Average Yield on Loans	10.46	15.32	10.91	10.39	16.65	10.97
Average Cost of Deposits	0.08	0.15	0.08	0.08	0.17	0.08
Liquidity Ratio (PR-10)	90.06	164.97	90.26	91.80	163.58	91.97
Net Loans to Total Assets	11.30	36.43	11.88	10.06	36.04	10.60
Customer Deposits to Total Loans	835.70	20.95	760.72	945.05	20.57	861.04
Cash Balances to Short Term Liabilities	0.79	21.50	0.85	0.75	19.97	0.80

Summary Balance Sheet Calendar Year to Date Amounts (in U.S. '000s)	CYE2015			CYE2016		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Cash and Due from Other Banks	212,057	1,036	213,093	246,381	1,060	247,441
Net Loans	27,427	2,090	29,517	27,914	2,099	30,013
Gross Loans	*28,392*	*2,878*	*31,270*	*28,695*	*2,868*	*31,563*
Provisions for Bad Loans	*(965)*	*(788)*	*(1,753)*	*(781)*	*(769)*	*(1,550)*
Performing Loans	*27,891*	*2,722*	*30,613*	*28,503*	*2,815*	*31,318*
Non Performing Loans	*501*	*156*	*657*	*192*	*53*	*245*
******Past Due Loans (includes NPLs)******	*1,406*	*377*	*1,783*	*840*	*243*	*1,083*
Other Assets	3,146	2,611	5,757	3,155	2,665	5,820
TOTAL ASSETS	**242,630**	**5,737**	**248,367**	**277,450**	**5,824**	**283,274**
Total Deposits	237,273	603	237,876	271,181	590	271,771
Demand/Checking	*99,738*	*0*	*99,738*	*103,950*	*0*	*103,950*
Savings	*125,283*	*581*	*125,864*	*153,165*	*576*	*153,741*
Time Deposits	*12,252*	*22*	*12,274*	*14,066*	*14*	*14,080*
Other Liabilities	2,362	1,944	4,306	2,276	1,982	4,258
TOTAL LIABILITIES	**239,635**	**2,547**	**242,182**	**273,457**	**2,572**	**276,029**
Issued and Fully Paid Up Common Stock	NA	4,105	4,105	0	4,105	4,105
Paid-in Premium	NA	0	0	0	0	0
Retained Profits (Losses)	2,995	(915)	2,080	3,993	(853)	3,140
Other Changes to Capital	0	0	0	0	0	0
TOTAL CAPITAL	**2,995**	**3,190**	**6,185**	**3,993**	**3,252**	**7,245**
TOTAL LIABILITIES & CAPITAL	**242,630**	**5,737**	**248,367**	**277,450**	**5,824**	**283,274**

APPENDIX

	As of Calendar Year-End 2016[1] (In U.S. Thousands)					As of Calendar Year-End 2016 (In U.S. Thousands)		
Statements of Condition figures published by all banks	Bank of Hawaii	Bank of Guam	BankPacific[2]	Palau Construction Bank	Asia Pacific Commercial Bank	**Insured Banks**	**Uninsured Banks**	**Aggregate All Banks**
Cash & Due From Banks	782	487	317	792	286	2,664	1,078	3,742
Net Loans	17,474	9,032	2,057	1,304	795	30,662	2,099	32,761
Other Assets[3]	123,552	97,094	19,569	650	85	240,215	735	240,950
TOTAL ASSETS	**141,808**	**106,613**	**21,944**	**2,746**	**1,166**	**270,365**	**3,912**	**274,277**
Deposits	136,604	106,572	22,000	475	115	265,766	590	266,356
Other Liabilities	39	41	39	48	21	119	69	188
TOTAL LIABILITIES	136,643	106,613	22,040	523	136	265,295	659	265,954
CAPITAL	5,165	0	(96)	2,223	1,030	8,322	3,253	11,575
TOTAL LIABILITIES & CAPITAL	**141,808**	**106,613**	**21,944**	**2,746**	**1,166**	**270,365**	**3,912**	**274,277**
Statements of Income (Loss) figures published by all banks	Bank of Hawaii	Bank of Guam	BankPacific[2]	Palau Construction Bank	Asia Pacific Commercial Bank	**Insured Banks**	**Uninsured Banks**	**Aggregate All Banks**
Interest Income	4,174	1,517	172	320	189	6,371	509	6,880
Interest Expense	45	136	14	1	1	197	2	199
NET INTEREST INCOME	**4,129**	**1,381**	**157**	**319**	**188**	**5,667**	**507**	**6,174**
Non Interest Income	616	237	98	37	4	992	41	1,033
Non Interest Expense	1,153	1,046	351	236	222	2,551	458	3,009
Net Income (Loss) before Tax	3,592	571	(96)	120	(30)	4,067	90	4,157
Less: Applicable Net Income Tax	116	27	0	8	3	154	11	165
NET INCOME (LOSS) after Tax	**3,476**	**543**	**(96)**	**112**	**(33)**	**3,924**	**79**	**4,003**

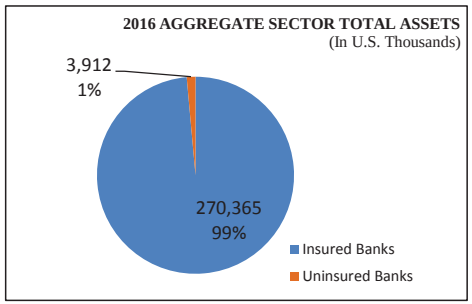
1/ All banks published Statements of Condition and Statements of Income (Loss) by March 1st 2017 with postings in bank lobbies

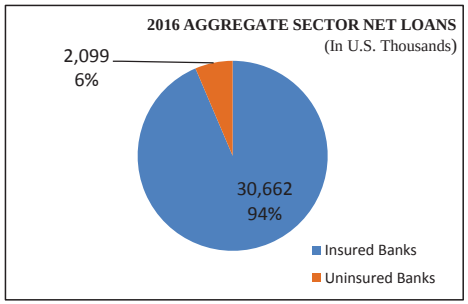
2/ BankPacific's figures are as of June 30, 2016, since the bank's fiscal year ends on June 30th.

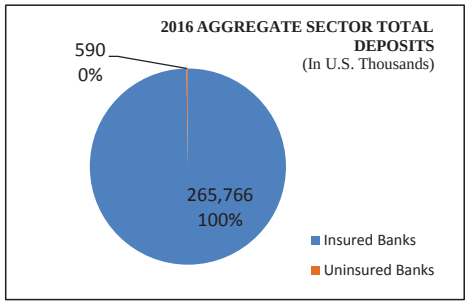
3/ includes fixed assets and accrued receivables other than loans; for Bank of Hawaii, Other Assets includes balances Due From Home Office

Key Ratios

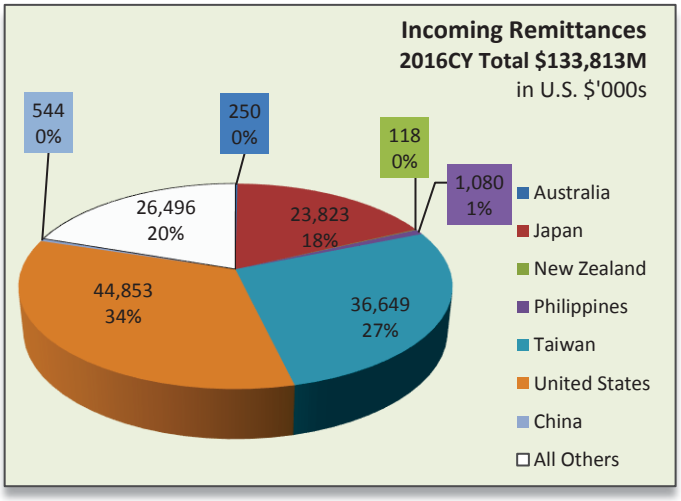
Return on Assets	2.45%	0.51%	-0.44%	4.08%	-2.83%	1.45%	2.02%	1.46%
Return on Equity				5.04%	-3.20%		2.43%	
Capital to Assets				80.95%	88.34%		83.15%	
Liquid Assets to Total Deposits	1%	0.5%	1%	167%	249%	1%	183%	1%
Deposits to Net Loans	782%	1180%	1069%	36%	14%	867%	28%	813%

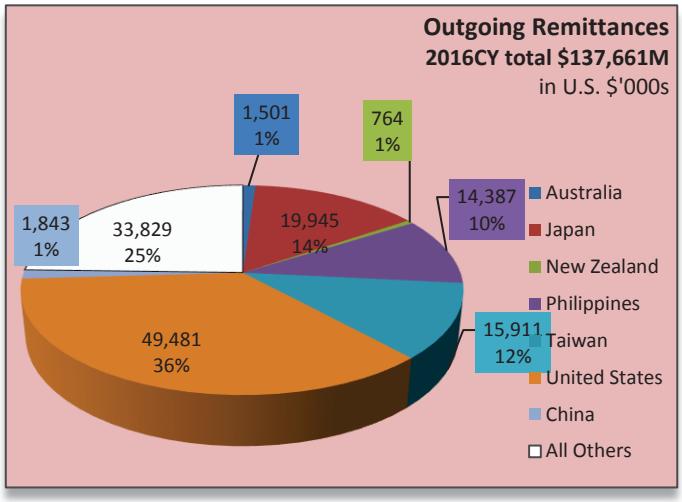






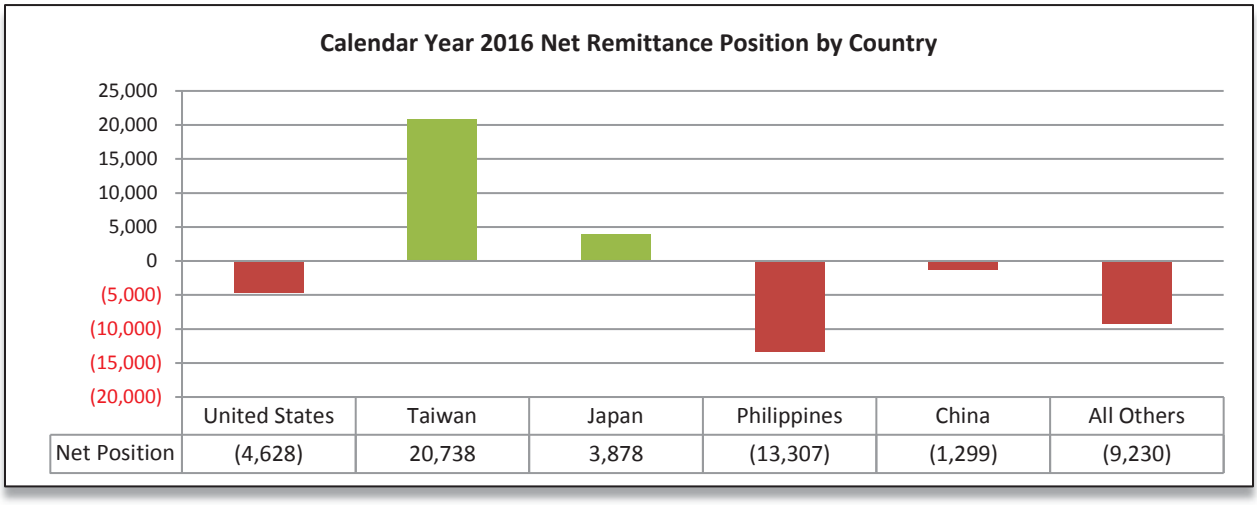
from Annual Statements of Condition for all banks in Palau published and posted on March 1st by all banking institutions pursuant to FIC regulatory requirements (PR-11)



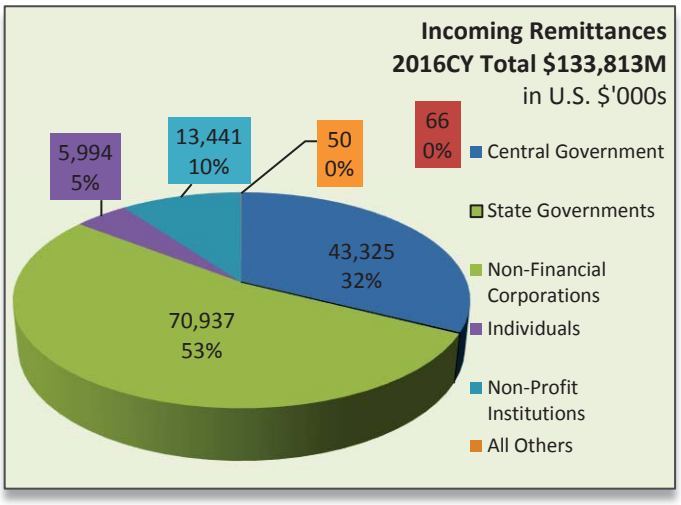


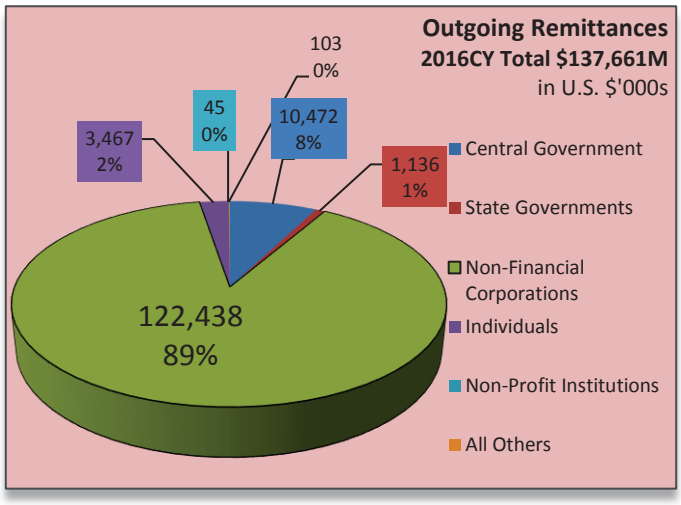
In U.S. Thousands of Dollars	CY2015	CY2016	% Change	4th Qtr 2015	4th Qtr 2016	% Change
Incoming Remittances	**137,565**	**133,813**	**-3%**	**34,469**	**31,206**	**-9%**
United States	48,495	44,853	-8%	9,840	8,716	-11%
Taiwan	27,677	36,649	32%	9,951	9,787	-2%
Japan	26,626	23,823	-11%	8,631	5,803	-33%
China	4,814	544	-89%	96	218	127%
All Others*	29,953	27,944	-7%	5,951	6,682	12%
Outgoing Remittances	**151,603**	**137,661**	**-9%**	**32,361**	**37,730**	**17%**
United States	68,476	49,481	-28%	15,542	10,033	-35%
Taiwan	12,452	15,911	28%	2,211	4,745	115%
Japan	21,249	19,945	-11%	5,292	4,920	-7%
Philippines	11,072	14,387	30%	1,692	3,789	124%
China	1,843	1,843	-1%	30	1	-97%
All Others**	36,094	36,094	**-3%**	7,594	14,242	88%

*Includes wires from: Australia, NZ, Philippines, and unspecified countries grouped in "All Others" category
** Includes wires to: Australia, NZ, and unspecified countries grouped in "All Others" category

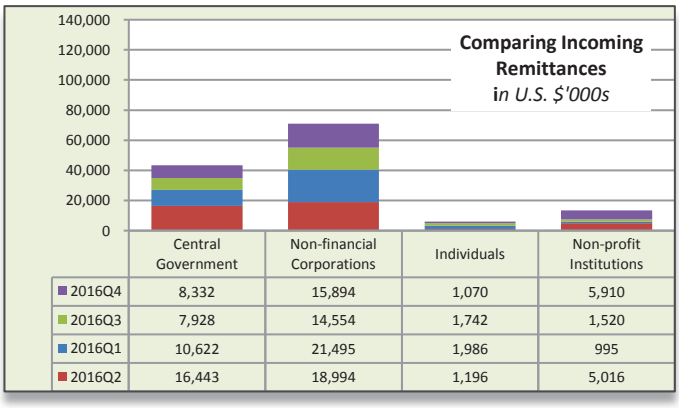


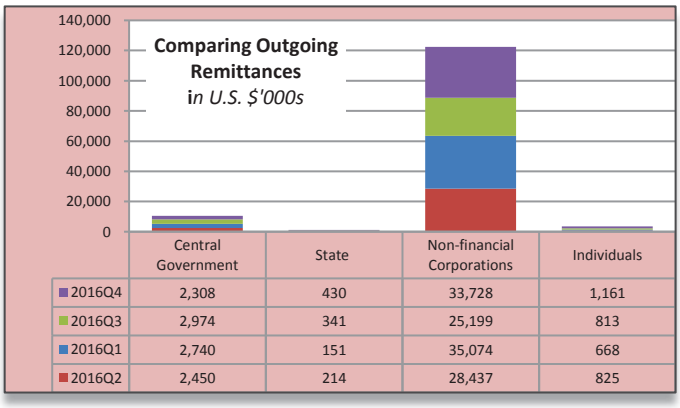
Reported figures show **Net Outbound Position** for calendar year 2016 with total Outgoing wires exceeding total Incoming wires by approximately $3.8MM.





In U.S. Thousands of Dollars	CY2015	CY2016	% Change	4th Qtr 2015	4th Qtr 2016	% Change
Incoming Remittances	**137,565**	**133,813**	**-3%**	**34,469**	**31,206**	**-9%**
Non-financial Corporations	73,446	70,937	-3%	17,018	15,894	-7%
Central Government	34,662	43,325	25%	10,465	8,332	-20%
Individuals	15,611	5,994	-62%	898	1,070	19%
Non-profit Institutions	13,005	13,441	3%	5,353	5,910	10%
All Other Sectors	841	116	-86%	735	0	-100%
Outgoing Remittances	**151,603**	**137,661**	**-9%**	**32,361**	**37,730**	**17%**
Non-financial Corporations	137,095	122,438	-11%	30,094	33,728	12%
Central Government	9,211	10,472	14%	1,400	2,308	65%
Individuals	4,162	3,467	-17%	707	1,161	64%
All Other Sectors	1,135	1,284	13%	160	533	233%





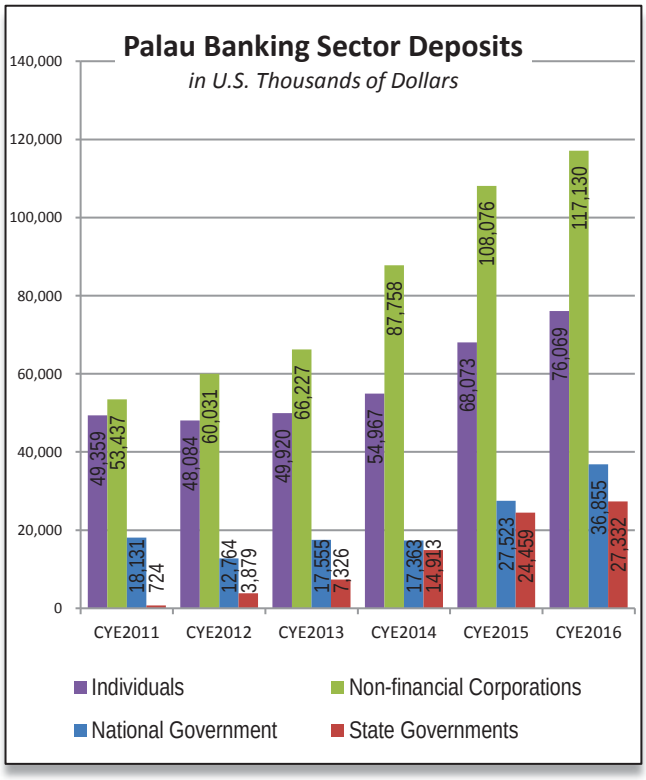
Above bar charts exclude other sectors.

HIGHLIGHTS

- Local companies (non-financial corporations) experienced a $2.5MM, or 3%, decline in funds received from abroad compared to last year, and at the same time wired out 11%, or approximately $14.6MM, less funds during 2016.
- Incoming remittances received by Individuals substantially declined in 2016 compared to 2015. The total of funds received by Individuals in Palau during the 2016 calendar year are approximately $9.6MM less than the amount recorded for the previous year, a 62% decline. Funds wired outside Palau by Individuals also declined during 2016 compared to the previous year, having decreased 17%, or by $695M compared to calendar year 2015.
- Wires from Taiwan increased 32%, or by $9MM, whereas wires from China declined by 89%, or $4MM.

CYE2016 Summary Report on Year-on-Year Deposit Level Changes
Republic of Palau Banking Sector

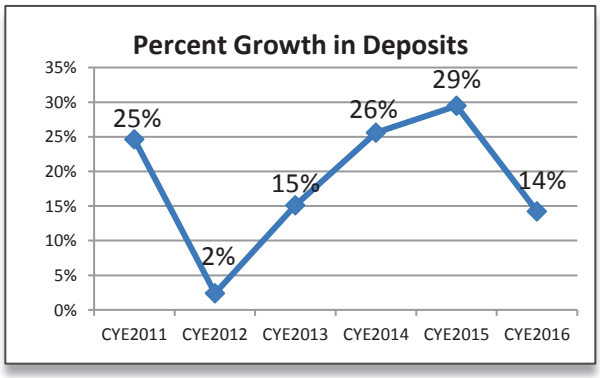
Total Deposits for the industry grew from approximately $238MM to $272MM during the 2016 calendar year, an increase of approximately $34MM, or 14%. The rate of deposit growth may be waning, yet this further expansion is significant and once again the issue of where these funds are coming from arises.



The deposits of Non-financial Corporations show 8% growth, or increase of approximately $9MM, in 2016. This is notably lower compared to the 23% or approximately $20MM growth in total volume of deposits seen during 2015. Expansion in tourism in prior years has largely driven exponential growth in Business sector deposits. Thus, the slowdown in deposit growth is attributable to stabilizing factors in the tourism sector. Last year's drought and cessation of charter flights resulted in a decline in tourism. The government statistics office has reported that tourist numbers fell from approximately 162,000 in 2015 to approximately 138,000 in 2016. These are tourist and business arrival figures sourced from the Bureau of Immigration and the Office of Planning & Statistics.

Despite the decline in tourism, the continuing expansion in business deposits appears to be correlated with observed increase in capital and infrastructure development and construction activities.

The deposits of Individuals also show moderate growth of 12% or approximately $8MM during 2016 compared to $13MM or 24% increase over the prior year. Implementation of the minimum wage legislation also contributed to growth in the deposits of individuals as illustrated by a correlating increase in total wages paid from approximately $115MM to $126MM for 2015 and 2016, respectively, as reported from Social Security Administration data. It is noted that these deposits also include the accounts of Individual entrepreneurs used for business purposes and those of individuals acting as "fronts" for foreign businesses which have noticeably increased throughout Koror and are observed to be expanding to Airai and the rest of Babeldaob.



Note: Deposits of Insured bank branches are backed by the U.S. FDIC and the insured group of banks hold virtually all deposit liabilities for the banking sector. Uninsured locally chartered banks hold less than 1% of the local banking sector's deposits.

The tables on the following pages show the values of deposits in U.S. thousands of dollars and are segregated by type of depositor into five major categories. Three of these major categories are further divided into sub-categories in a way that makes it easier to identify the source of increase (or decrease) in deposit levels. Also shown are year-on-year growth in dollar amount and percent.

AGGREGATE OF DEPOSITS AT PALAU LICENSED BANKS[1]

(in U.S. thousands of dollars)	CYE2014	CYE2015	CYE2016
Deposits - Other Financial Corporations	**7,569**	**8,950**	**13,524**
Development Financing Corporations	285	191	5,036
Others	7,284	8,759	8,488
Deposits - Government	**32,276**	**51,982**	**64,187**
National Government	17,363	27,523	36,855
State Governments	14,913	24,459	27,332
Deposits - Public Non-financial Corporations	**705**	**125**	**133**
Deposits - Private Sector	**142,725**	**176,149**	**193,199**
Non-financial Corporations	87,758	108,076	117,130
Individuals	54,967	68,073	76,069
Deposits - Non-residents	**4**	**68**	**0**

Growth year-on-year, volume change (in U.S. thousands of dollars)	CYE2014	CYE2015	CYE2016
Deposits - Other Financial Corporations	**3,285**	**1,381**	**4,574**
Development Financing Corporations	86	(94)	4,845
Others	3,199	1,475	(271)
Deposits - Government	**7,395**	**19,706**	**12,205**
National Government	(192)	10,160	9,332
State Governments	7,587	9,546	2,873
Deposits - Public Non-financial Corporations	**114**	**(580)**	**8**
Deposits - Private Sector	**26,578**	**33,424**	**17,050**
Non-financial Corporations	21,531	20,318	9,054
Individuals	5,047	13,106	7,996
Deposits - Non-residents	**0**	**64**	**(68)**

Growth year-on-year, percent change	CYE2014	CYE2015	CYE2016
Deposits - Other Financial Corporations	**77%**	**18%**	**51%**
Development Financing Corporations	43%	-33%	2537%
Others	78%	20%	-3%
Deposits - Government	**30%**	**61%**	**23%**
National Government	-1%	59%	34%
State Governments	104%	64%	12%
Deposits - Public Non-financial Corporations	**19%**	**-82%**	**6%**
Deposits - Private Sector	**23%**	**23%**	**10%**
Non-financial Corporations	33%	23%	8%
Individuals	10%	24%	12%
Deposits - Non-residents	**0%**	**1600%**	**-100%**

[1] Aggregate total is net of total reported deposits of depository institutions

BANKING INSTITUTIONS OPERATING IN PALAU

As of January 2017

Bank Name	Home Country Charter	Date of Charter	License Status	Primary Regulator	Local Management	Address	Contact Information
Asia Pacific Commercial Bank	Palau	1/21/2000	Active	FIC	Mr. Mun Chee Woo, *VP* Ms. Florencia Rirou, *Bank Manager*	Ikelau, Koror P.O. Box 10025 #2B-105 Republic of Palau 96940	Tel. 488-8388 / 488-8981 Email: asiapac@palaunet.com
Bank of Guam	Guam	Guam: 1972 Opened Palau branch: 3/13/1984	Active	U.S. FDIC	Mr. Joseph D. Cruz, *VP/Branch Manager*	Dngeronger, Koror P.O. Box 338 Republic of Palau 96940 http://www.bankofguam.com	Tel. 488-2696 / 488-2697 Email: bog@palaunet.com Email: joseph.cruz@bankofguam.com
Bank of Hawaii	Hawaii	9/18/1961	Active	U.S. Federal Reserve	Mr. Richard Ziegler, *VP/Palau Island Manager*	Medalaii, Koror P.O. Box 340 Republic of Palau 96940 http://www.boh.com	Tel. 488-2602 / 488-3285 Email: Richard.Ziegler@boh.com
BankPacific, Ltd.	Guam	7/28/1995	Active	U.S. FDIC	Mr. Joseph Koshiba, *Branch Manager*	Dngeronger, Koror P.O. Box 1000 Republic of Palau 96940 http://www.bankpacific.com	Tel. 488-5635 / 488-5226 Email: joek@bankpacific.com
Palau Construction Bank	Palau	7/28/1995	Active	FIC	Ms. Lucia Tellei, *General Manager*	Meyuns, Koror P.O. Box 7077 Republic of Palau 96940	Tel. 488-1946 / 488-5888 Email: pc.bank@palaunet.com
National Development Bank of Palau	Palau	2/24/1982	*pending*	FIC	Ms. Claire Harvey, *President* Ms. Karla West, *Operations Manager*	Ngetkib, Airai P.O. Box Republic of Palau 96940	Tel. 587-2578 Email: charvey@ndbp.com, or kwest@ndbp.com