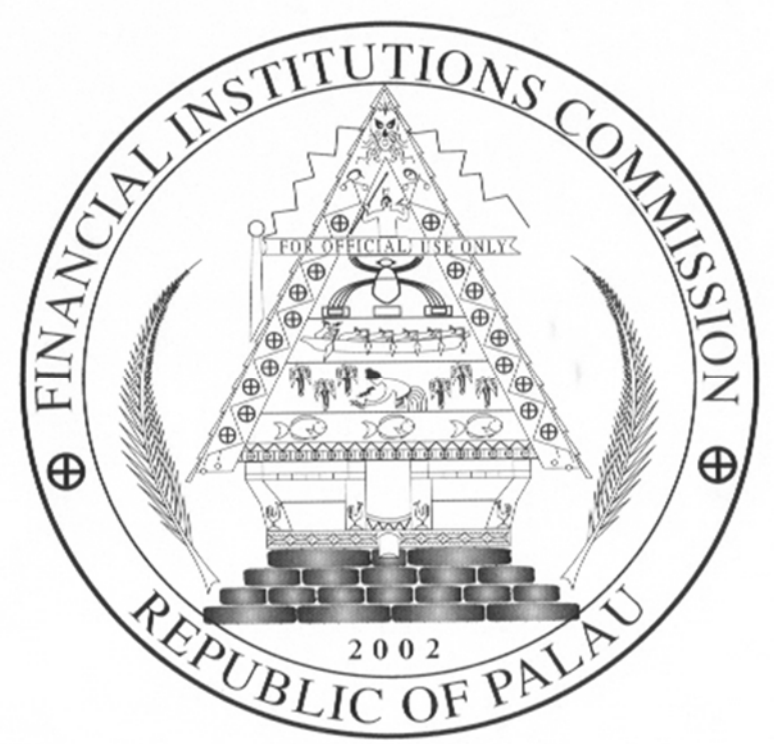
Annual Report of the Palau Banking Sector

for Calendar Year 2018



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Summary Assessment

The overall condition of the Palau banking sector remains satisfactory. Growth and stability are maintained.

- Total Assets of all licensed banks declined by 6.7% during the year commensurate with contraction in customer deposits. The reversal in the sector's expansion correlates with reduction in tourism numbers and related economic activity.
- Asset quality indicators remain satisfactory. The industry ratio of Non-Performing Loans (NPLs) to Total Loans remains low and is relatively stable at 0.60% compared to 0.61% last year. The volume of outstanding loans decreased by 8% or approximately $3MM due to one large credit exposure that affected the overall total. Provisions for Bad Loans remain more than adequate to mitigate against potential losses, at six times the sector's volume of Non-Performing Loans.
- Return on Assets increased from 1.59% to 1.99%. The primary contributors to increased profitability for the banking sector is the notable increase in returns on excess liquidity invested abroad by U.S. banks maintaining due from Home Office balances for branches in Palau.
- Liquidity remains adequate and all banks demonstrate the ability to continually meet depositor demand. There are high levels of liquidity maintained by banks and in aggregate, approximately $238MM of the sector's $276MM total assets are liquid assets as defined by FIC regulation PR-10. At year-end, there was approximately ninety-five cents held by banks for every dollar in customer deposits and short term liabilities. Funds management practices are adequate for the scope of local banking operations, as supported by onsite exam findings. Funds management practices 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.
- Aggregate capital for the two locally chartered banks grew 6% in 2018. Uninsured locally chartered banks demonstrate the desire to maintain capital growth and have achieved consistent profitability as a result of improvements in governance and better management of operational risks.
- U.S. bank branches remain dominant in the industry and altogether hold 98% of the sector's assets as of December 31, 2018. All U.S. banks operating in Palau are in good standing with their primary regulators in the U.S., continue to maintain access to U.S. capital markets, and invest Palau's excess liquidity in relatively safe securities and assets abroad. Because of U.S. FDIC deposit insurance, the U.S. bank branches are not required to maintain capital or assigned capital in Palau, whereas locally chartered banks and foreign bank branches or subsidiaries whose deposits are not insured by a government sponsored agency are required to maintain capital levels and capital ratios in accordance with requirements in the Financial Institutions Act and the FIC's prudential regulations.

*[Notes: (1) For the purposes of this report, numbers accompanied by the Roman numeral "**M**" represent figures in thousands, and "**MM**" shall represent figures in millions; (2) "sector" and "industry" are used interchangeably in this report but both refer to licensed deposit-taking institutions operating in the Republic of Palau]*

New Developments

APG Mutual Evaluation of the Republic of Palau

The final report[1] of the findings and recommendations stemming from the 2017 Mutual Evaluation was presented at the APG's Annual Plenary, which was held in Kathmandu, Nepal from July 21-27, 2018. The last Mutual Evaluation of Palau was conducted in 2008.

Governing Board of Commissioners

Mr. Tutii Chilton, whose current term on the Board of the FIC ends on October 18, 2019, remains the Chairperson of the FIC Board. The Board has not yet reorganized since the term of Ms. Uroi Salii, former Vice Chairperson, ended on November 3, 2018. The OEK confirmed new Board members Ms. Landisang Kotaro and Mr. Kevin Mesebeluu in October 2018. On January 22, 2019, Mrs. Jennifer Koskelin-Gibbons was re-confirmed to the Board while at the same time new Board member Mr. Vance Polycarp was confirmed by the OEK.

Regular sessions of the FIC Governing Board continue to be scheduled for every second Wednesday of each month, 9 a.m., at the FIC Office. Regular sessions are open to the public.

FIU Regulations

Regulations for the prevention and deterrence of money laundering and terrorism financing were put into effect in 2018. These regulations are promulgated in the Money Laundering and Proceeds of Crime Act and are enforced by the office of the Financial Intelligence Unit.

New Banking License Applications

During 2018, there were a number of informal inquiries into obtaining a license from the FIC, however, there were no complete applications submitted to the agency.

IMF, PFTAC and the AFSPC

Annual AFSPC Meeting

The annual meeting of Pacific Island financial sector supervisors was held in Vanuatu during August 2018. Palau was represented in the meeting by FIC Governing Board Chairman Tutii Chilton, Executive Commissioner Semdiu Decherong and Senior Bank Examiner Lindsay Timarong. The series of workshops in the days following the annual meeting featured presentations and case studies on new and emerging financial technologies, crypto-assets, and a simulated systemic crisis involving an escalated bank hacking incidence based on real life experiences.

Amendments to the Financial Institutions Act of 2001

PFTAC began assisting the FIC with the drafting of amendments to Palau's banking legislation. These amendments are intended to enhance legislation to include provisions that address new financial technologies, as well as to define and clarify prohibited offshore banking activities, among others. Two legal advisors were sent to Palau during 2018 to review legislation and draft language for the amendments to the Financial Institutions Act.

[1] Mutual Evaluation Reports are published on the APG website http://www.apgml.org/documents/

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 and 8th Olbiil Era Kelulau (OEK or National Congress) under Republic of Palau Public Laws 7-41 and 8-28, respectively. 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.

In 2016, the FIC developed an internship program through a collaborative arrangement with the Palau National Scholarship Board. The agency hired an **Intern** for the first time during that year and welcomed Ms. Isola E.

Solang, who 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. No other intern has been selected to date.

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 33, 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 2018 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, 2018, the U.S. bank branches hold approximately 90% of the banking sector's aggregate Loans and 99% of the sector's aggregate Total Deposits. [2]

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.[3] 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 provided to the Executive Commissioner. 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 the *Olbiil Era Kelulau* (OEK or national congress) 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 tenth annual report published by the FIC. 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 2018 calendar year. Examinations were conducted on Asia Pacific Commercial Bank, Palau Investment Bank, the Koror branch of Bank of Guam, as well as the Koror branch of Bank of Hawaii.

[2] 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.

[3] 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.

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. Moreover, the Bank Examiner has successfully completed the U.S. FDIC's Examination Management School, an achievement that is a federal test away from earning the prestigious Commissioned Examiner status for U.S. bank examiners. Palau's Bank Examiner 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 PERFORMANCE

CAPITAL ADEQUACY (Uninsured banks):

- **Aggregate capital for uninsured banking institutions continues its upward trend and increased by 6%, or $228M, during the year.** Consistent earnings performance of the two locally chartered banks has resulted in aggregate capital accretion. Each locally chartered bank is required to maintain at least one million U.S. dollars in capital in accordance with the banking legislation.
- 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 2017 and 2018 calendar years. As of the calendar year ended December 31, 2018, 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 despite decline from approximately $291MM to $276MM during 2018. The contraction in sector size is commensurate with decrease in deposits.

  The quality of the sector's loan portfolio continues to be satisfactory. The ratio of Non-Performing Loans to Total Loans remains nominal and stable at 0.60%. The total volume of Non-Performing Loans (NPLs) fell 6% or from $217M to $203M during 2018.
- Total loans decreased by 6%, or $2.2MM, during 2017 as a result of contraction in both aggregate business and personal loans. Business loans (i.e. loans to Non-financial corporations) declined by approximately $1M, whereas loans to individuals declined by approximately $1.2MM. Unsecured loans, which comprise 79% of the sector's portfolio, fell by 5%, or approximately $1.5MM. Despite the relatively higher volume of commercial loans compared to prior years, usage of the Secured Transactions Registry has not correlated with expansion in secured lending. Ultimately, it is a bank's business decision whether or not to incur the expense of additional protection of its lien position over collateral by utilizing the Secured Transactions Registry, although the FIC continues to strongly promote the registry with banks and creditors seeking protection in secured financing transactions.
  - *Insured U.S. banks* continue to hold 98% of the banking sector's total assets; approximately $30MM of the sector's total loans; and approximately $109M of the sector's Non Performing Loans as of year-end.[4]
- **Provisions for Bad Loans remain adequate for all commercial banks**. Aggregate Provisions for Bad Loans are over seven times the level of Non-Performing Loans for the banking sector, indicating that there is sufficient cushioning that well exceeds the potential for loan losses and the FIC's provisioning criteria. Banks maintain relatively conservative charge-off policies and practices, yet the ratio of loan charge-offs to average total loans is minimal at 2%. Recoveries on loans written-off continues to be strong and during 2018, banks collected approximately 43% of the previous year's level of charge-offs.
- Due From Home Office balances of U.S. Branches comprise 85% of the banking sector's Total Assets. Approximately $234MM of the industry's $238MM 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**. Although, there appears to be a lag in response to the increasing effective Federal

[4] 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.

Funds Rate for some branches. The overnight interbank lending rate is deemed by the FIC to be a fair return at minimum on Palau excess depositor funds used for investment abroad.

EARNINGS PERFORMANCE:

- **Earnings performance for the sector continues to be satisfactory.** Most banks generated profits during the calendar year. Overall, stable profitability is expected for the sector and there continues to be potential to expand lending locally given sustained excess liquidity.
  - Return on Assets (ROA) for the overall sector has increased from 1.59% to 1.99% during 2018—an increase commensurate with increase in interest income from earning assets relative to contraction in total assets. According to interest rate surveys conducted last year, deposit rates are maintained within a range of between 0.01% and 2%. Lending rates remain capped at 18% due to standing legislation and variable rates have increased as commensurate with interest rate hikes in the U.S. Unsecured consumer loan fixed rates ranged from 11% at the lowest, whereas business loans may yield as low as 7% depending on subjective criteria specific to each bank's credit policy.
  - Net Interest Margin (NIM)[5] increased from 2.59% to 2.94%. On the other hand, Yield on Loans has slightly declined from 10.47% to 10.18% compared to prior year-end, suggesting that the growth in asset yields outpaced the rate of growth in earning assets. In other words, higher returns made up for the contraction in assets overall. Although the volume of loans and due from balances declined, income from loans and excess liquidity invested abroad by the three large U.S. bank branches were higher as a result of increased rates commensurate with U.S. rate hikes.
  - The yield on local branch balances maintained at U.S. bank Home Offices indicate strong earnings from the investment of excess funds outside Palau. The estimated average yield on aggregate balances Due from Home Office & Other branches of the *Insured group of banks* has increased from 1.45% last year-end to 1.92%. 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 2018 was 1.82%.

Palau Banking Sector

Condensed Income & Expense Statement

Annualized (in U.S. '000s)	CYE2017			CYE2018		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Interest And Fee Income	6,880	574	7,454	8,049	658	8,707
Interest Expense	228	6	234	326	0	326
NET INTEREST INCOME	**6,652**	**568**	**7,220**	**7,723**	**658**	**8,381**
Provisions For Bad Loans Expense	**473**	**3**	**476**	**308**	**(12)**	**296**
NON-INTEREST INCOME	**984**	**2**	**986**	**967**	**9**	**976**
NON-INTEREST EXPENSE	**2,474**	**402**	**2,876**	**2,611**	**411**	**3,022**
NET INCOME (LOSS) BEFORE TAXES	4,689	165	4,854	5,771	268	6,039
Less: Applicable Income Taxes	174	12	186	217	14	231
Year-to-date Income (Loss)	**4,515**	**153**	**4,668**	**5,554**	**254**	**5,808**

[5] 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.

LIQUIDITY ADEQUACY:

- **Liquidity continues to be strong for all banks in the sector.**
- The Liquidity Ratio calculated for the banking sector, at 96%, continues to be stable and growing. This means that for every dollar in short term liabilities, the banking sector maintained 96 cents in liquid assets. Liquid assets[6] declined by approximately $12MM, or 4.7% during 2018, which is commensurate with the decrease in short term deposit liabilities.
- Even though local liquid assets (i.e. cash balances) aggregated for *Insured branch institutions* cover just 1.18% 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**.
- Total Deposits for the banking sector declined by 5.6%, or by approximately $15.5MM, during the calendar year and totaled approximately $263MM at the most recent year-end.

The ratio of Total Deposits to Total Loans increased from 778% to 782%, commensurate with deposit growth outpacing loan growth. This ratio means that on average, for every dollar in loans, the sector maintains approximately $7.82 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 has historically maintained a net outbound position in remitted funds, meaning more funds are sent outside Palau than are received by local institutions. However, during 2018, aggregate wire activity shows approximately $3.9MM more funds were received than were sent out.

- **A total of approximately $210MM came into Palau and approximately $206MM was sent abroad during the 2018 calendar year** through the local banking sector. Remittances to and from the U.S., Japan, China and Taiwan – our main trading partners – top the list.
- Remittances received in Palau from those three above listed countries together comprise 84%, or approximately $176.5MM, of total funds received during 2018. Of the total Outgoing wire transfers during 2018, approximately $166.5MM in funds, or 81%, were sent to those same three countries listed above. Another $15.5MM was sent via wire transactions to the Philippines during the year.
- National government received approximately $81MM, or 210%, more in funds compared to the previous year. These additional funds reflect the monies due to Palau from the U.S. government resulting from U.S. funding of the Compact 2 agreement that was signed back in 2010.

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.

[6] 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.

- ❖ The sum of the number of Depositors reported by all licensed banks increased compared to the prior year, despite contraction in the sector's volume of funds held in deposit accounts. The aggregate total number of Depositors grew from 19,534 to 20,002. 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 6,667—up from 6,511 last year. The number of deposit accounts totaled 22,687, which is notably higher than the 21,123 aggregate figure from last year.
- ❖ The aggregate number of Loan Accounts decreased from 5,971 to 5,681 during the year, commensurate with decline in the total aggregate number of Borrowers summed for all licensed banks, which declined from 5,465 to 5,248. This is indicative of a healthy credit environment where borrowers have the ability and inclination to resolve their debts. Moreover, this demonstrates that there continues to be potential to expand lending and access to credit.

Key Performance Ratios & Summary Balance Sheet

KEY RATIOS (%)	CYE2017			CYE2018		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Total Capital to Total Assets	n.a.	59.30	n.a.	n.a.	64.62	n.a.
Tier 1 Leverage Capital Ratio	n.a.	56.79	n.a.	n.a.	60.35	n.a.
Tier 1 Risk Based Capital Ratio	n.a.	86.44	n.a.	n.a.	93.70	n.a.
Total Risk Based Capital Ratio	n.a.	91.68	n.a.	n.a.	101.76	n.a.
Non-Performing Loans to Total Loans	0.42	2.49	0.61	0.36	2.61	0.60
Provisions for Bad Loans to NPLs	616.18	832.10	696.77	684.40	783.0	730.05
Net Income to Average Assets (ROA)	1.57	2.57	1.59	1.94	4.21	1.99
Net Int Inc to Avg Earning Assets (NIM)	2.42	14.50	2.59	2.75	15.78	2.94
Average Yield on Loans	9.79	17.69	10.47	9.42	17.64	10.18
Average Cost of Deposits	0.08	1.12	0.09	0.12	0.00	0.12
Liquidity Ratio (PR-10)	90.54	153.00	90.68	217.33	1021.79	95.50
Net Loans to Total Assets	11.14	42.00	11.79	10.81	47.82	11.61
Customer Deposits to Total Loans	853.60	17.63	777.62	874.58	14.96	782.45
Cash Balances to Short Term Liabilities	0.52	16.72	0.56	1.18	19.16	1.23

Summary Balance Sheet Calendar Year to Date Amounts (in U.S. '000s)	CYE2017			CYE2018		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Cash and Due from Other Banks	248,857	970	249,827	237,202	797	237,999
Net Loans	31,826	2,577	34,403	29,222	2,861	32,083
Gross Loans	*32,519*	*3,251*	*35,770*	29,968	3,597	33,565
Provisions for Bad Loans	*(693)*	*(674)*	*(1,367)*	*(746)*	*(736)*	*(1,482)*
Performing Loans	*32,383*	*3,170*	*35,553*	*29,859*	*3,503*	*33,362*
Non-Performing Loans	*136*	*81*	*217*	*109*	*94*	*203*
*****Past Due Loans (includes NPLs)*****	*693*	*254*	*947*	*959*	*532*	*1,491*
Other Assets	3,833	2,588	6,421	3,864	2,325	6,189
TOTAL ASSETS	**284,516**	**6,135**	**290,651**	**270,288**	**5,983**	**276,271**
Total Deposits	277,582	573	278,155	262,093	538	262,631
Demand/Checking	*97,192*	*0*	*97,192*	91,008	0	91,008
Savings	*165,004*	*563*	*165,567*	139,466	526	139,992
Time Deposits	*15,386*	*10*	*15,396*	31,619	12	31,631
Other Liabilities	2,419	1,924	4,343	2,641	1,579	4,220
TOTAL LIABILITIES	**280,001**	**2,497**	**282,498**	**264,734**	**2,117**	**266,851**
Issued and Fully Paid Up Common Stock	0	4,135	4,135	0	4,114	4,114
Paid-in Premium	0	0	0	0	0	0
Retained Profits (Losses)	4,515	(498)	4,017	5,554	(249)	5,305
Other Changes to Capital	0	1	1	0	1	1
TOTAL CAPITAL	**4,515**	**3,638**	**8,153**	**5,554**	**3,866**	**9,420**
TOTAL LIABILITIES & CAPITAL	**284,516**	**6,135**	**290,651**	**270,288**	**5,983**	**276,271**

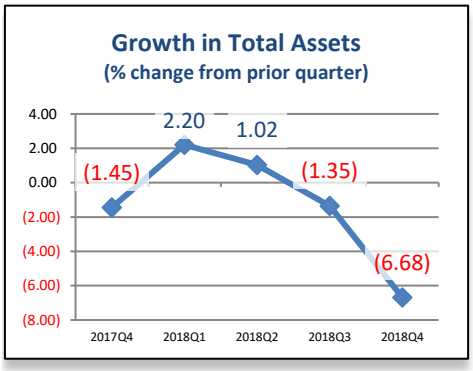
APPENDIX

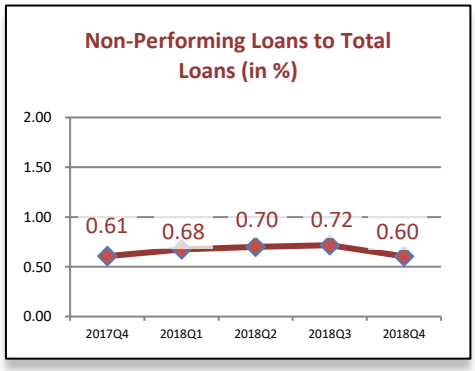
BANKING INSTITUTIONS OPERATING IN PALAU

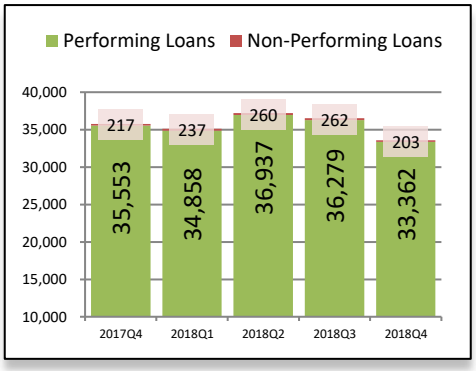
As of January 2019

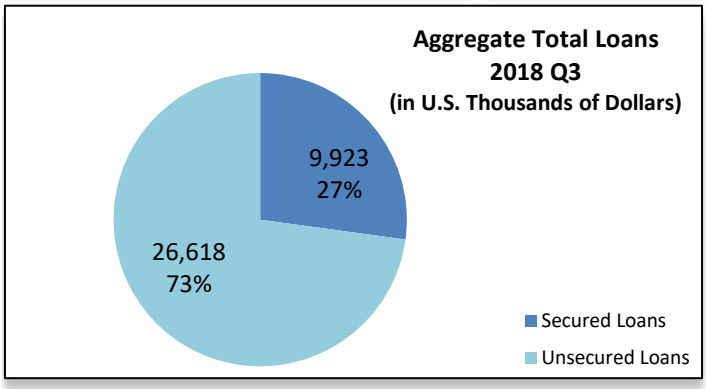
Bank Name	Home Country Charter	Date of Charter	License Status	Primary Regulator	Local Management	Address	Contact Information
Asia Pacific Commercial Bank	Palau	1/21/2000	Active	FIC	Ms. Florencia Rirou, *Bank Manager*	Ikelau, Koror P.O. Box 10025 #2B-105 Republic of Palau 96940	Tel. 488-8388 / 488-8981 Email: f.rirou@apcbpalau.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	Ms. Christina Michelsen, *VP/Palau Island Manager*	Medalaii, Koror P.O. Box 340 Republic of Palau 96940 http://www.boh.com	Tel. 488-2602 / 488-3285 Email: Christina.Michelsen@boh.com Email: Ives.Morei@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 Investment Bank formerly "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

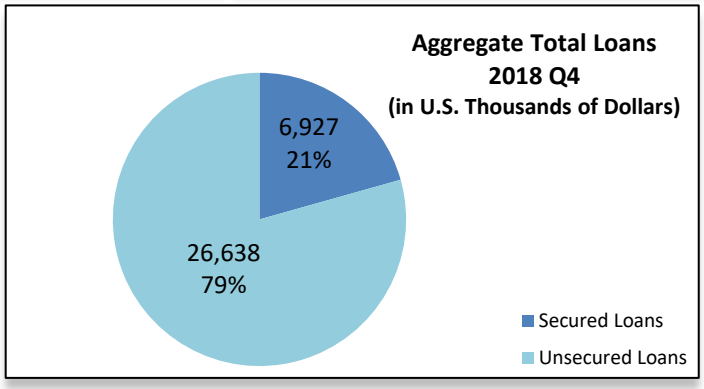
4th Quarter 2018 Banking Sector Key Performance Indicators

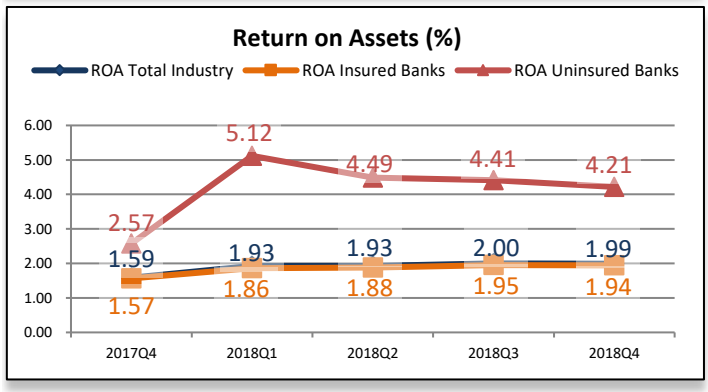


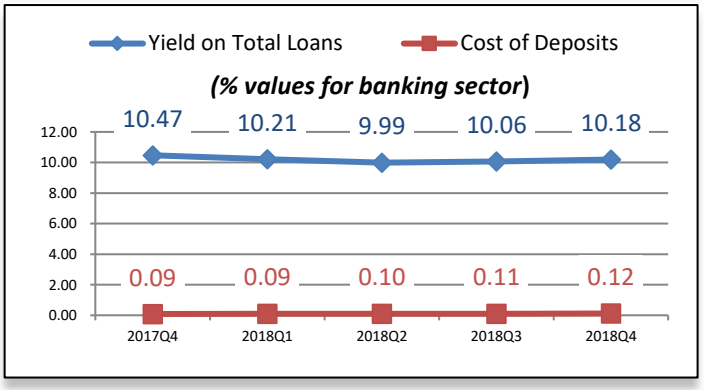


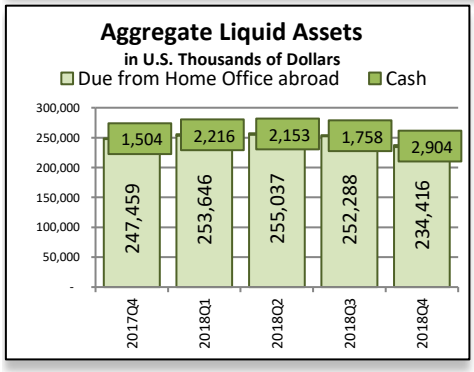


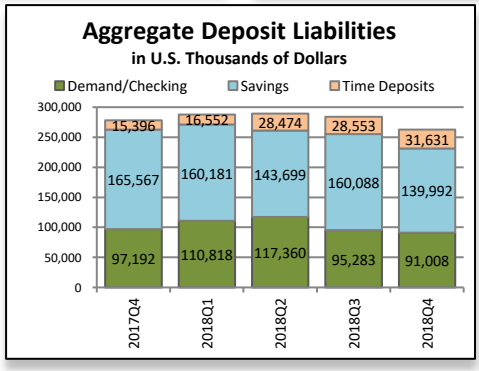


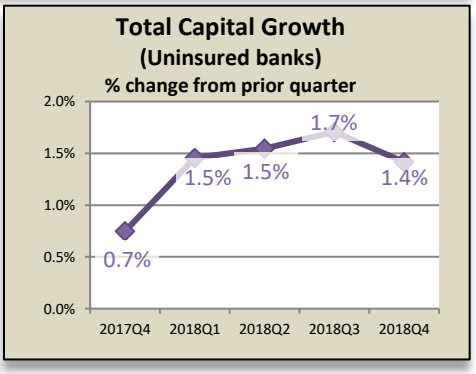










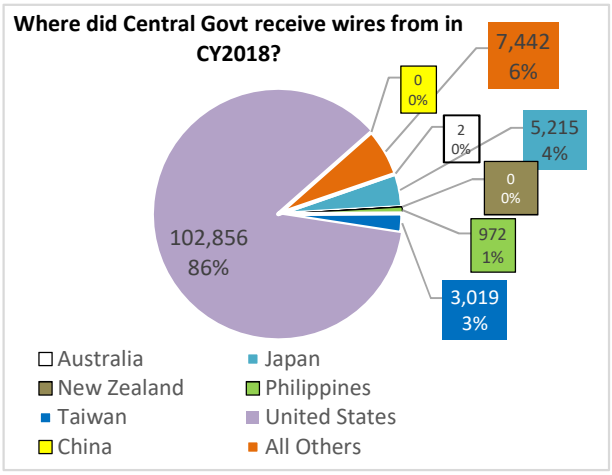
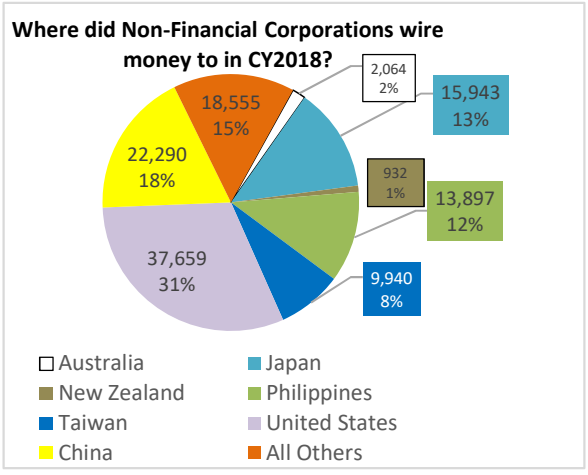


For the quarter *[values in U.S. thousands of dollars]*:

Change in Total Loans was **(2,976)** or -8.14% ; from 36,541 to 33,565

Change in Total Deposits was **(21,293)** or -7.50% ; from 283,924 to 262,631

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

By Country of Origin/Destination *in U.S. Thousands of Dollars*	CY2017	CY2018	$change	%change
Aggregate Incoming Wires	**119,147**	**209,999**	**90,852**	**76%**
United States	43,357	117,951	74,594	172%
Japan	27,796	25,569	(2,227)	-8%
Taiwan	14,581	15,529	948	7%
Philippines	818	1,514	696	85%
China	5,388	17,495	12,107	225%
All Others*(Australia, NZ, Others)	27,207	59,148	31,941	117%
Aggregate Outgoing Wires	**136,471**	**206,119**	**69,648**	**51%**
United States	48,195	111,878	63,683	132%
Japan	20,925	18,569	(2,356)	-11%
Taiwan	10,363	13,596	3,233	31%
Philippines	20,724	15,515	(5,209)	-25%
China	14,661	22,463	7,802	53%
All Others*(Australia, NZ, Others)	21,603	45,701	24,098	112%

By Economic Sector *in U.S. Thousands of Dollars*	CY2017	CY2018	$change	%change
Aggregate Incoming Wires	**119,147**	**209,999**	**90,852**	**76%**
Central Government	38,523	119,506	80,983	210%
Non-financial Corporations	63,676	75,148	11,472	18%
Individuals	6,644	8,740	2,096	32%
Non-profit Organizations	9,721	6,006	(3,715)	-38%
State Governments	40	378	338	845%
All Other Sectors* (Depository Insitutions, Other Financial Corporations, Statutory Non-financial Corporations, Non-residents)	543	5	(538)	-99%
Aggregate Outgoing Wires	**136,471**	**206,119**	**69,648**	**51%**
Central Government	11,151	75,574	64,423	578%
Non-financial Corporations	114,866	121,280	6,414	6%
Individuals	6,118	5,100	(1,018)	-17%
Non-profit Organizations	1,218	391	(827)	-68%
State Governments	503	215	(288)	-57%
All Other Sectors* (Depository Insitutions, Other Financial Corporations, Statutory Non-financial Corporations, Non-residents)	2,615	3,502	887	34%