2013 Annual Banking Sector Report

FINANCIAL INSTITUTIONS COMMISSION
of the
REPUBLIC OF PALAU

This report is provided pursuant to 26 PNC Chapter 10 §1016
(Also known as Section 12 of the Financial Institutions Act, RPPL 6-3, as Amended by 7-41 and 8-28).

G. Semdiu Decherong — **April 15, 2014**
Executive Commissioner — Date

2013 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. Aggregate capital for the two remaining locally chartered banks grew 8% during the year because of strong and consistent earnings generated by one bank in particular. Capital has exhibited an increasing trend and uninsured banks demonstrate the desire to maintain capital growth.

Asset quality indicators demonstrate improvements. Overall, the ratio of Non Performing Loans (NPLs) to Total Loans has remained relatively stable having only slightly increased from 3.57% to 3.83% from last year. The ratio of Loans past due 360 days or more to Total Loans has declined from 1.89% to 1.54% because of the 9%, or $48M, decrease in Uninsured Banks' volume of loans past due 360 or more days. Gross Loans have gone up 11.6% or by approximately $3MM since last year and Provisions for Bad Loans remain adequate to mitigate potential losses, covering 213% of the sector's Non Performing Loans.

Annualized earnings are lower compared to last year due to an increase in Provisions for Bad Loans Expense which is commensurate with loan growth.

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 have reliable access to adequate sources of funds abroad to meet anticipated local liquidity needs.

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

New Developments

There were notable operational changes within the Financial Institutions Commission (FIC) during 2013. On October 15, 2013, the FIC, together with the Financial Intelligence Unit (FIU), was officially relocated to the IA Meda Korner Building in Madalaii, Koror. Also, for the first time in 4 years, the FIC has a full board. The FIC Board officially welcomed Mrs. Jennifer Koskelin Gibbons in November 2013. Mrs. Gibbons was made a board member by Senate Resolution 9-85 adopted on October 17, 2013 becoming the fifth voting member on the agency's Governing Board of Commissioners. The terms of FIC Board members Ms. Uroi Salii and Mr. Tutii "Joe" Chilton, whose commissions ended in October and November, respectively, were extended last year.

The Secured Transactions Registry was officially launched and went online on January 7th, 2013. A small ceremony initiating the launch was held with Asian Development Bank (ADB) consultants Anthony Frazier and Terry Reed. ADB engaged an expert to identify opportunities in the markets and will develop products with proposed new laws that will encourage more lending in the Palau market.

The FIC officially implemented new prudential reporting forms in January 2013. Palau is the only jurisdiction in the North Pacific region that has implemented the new report format which includes statistical economic data in addition to the financial sector data that the FIC has been collecting. As a result of the expanded scope of information derived from the new reports, the FIC has begun a project to attempt to reconcile banking system data with economic statistics to better gauge the correlation and impact of economic activity on the banking sector.

An issue relating to whether or not U.S. bank branches operating in Palau could continue to offer the protection of U.S. FDIC insurance to local depositors was resolved during the year as a result of the efforts of Palau's lobbyists in Washington D.C. It was made clear that language in the compact agreement[1] between the Republic and the U.S. guarantees U.S. FDIC insurance for Freely Associated States. This consideration is also spelled out in amendments to FDIC regulations.

Bank of Guam made public their intention to enter into the mortgage lending market in Palau. The bank is working with the Palau Government on an agreement to have the Government guarantee such loans.[2]

Belau Community Credit Union (BCCU), the newest deposit taking institution in Palau, formally started its operations in March 2013. BCCU representatives met with the FIC Board in August 2013 and the credit union's officials stated their intent to service the niche in the lending market for residents who cannot get credit from the U.S. banks. Mr. Greg Ngirmang serves as the credit union's President, Kaleb Udui is its Vice President, and Francis Remengesau is the Secretary/Treasurer. Credit unions in the Republic of Palau will be required to be regulated by the FIC and the FIC is working with experts in this area to ensure that our laws are updated and that the FIC will be able to properly regulate these entities to safeguard credit union members from potential risk of loss to their deposits.

Melekeok Government Bank was formally dissolved in June 2013, with notices sent out to relevant agencies and related parties. The bank's license was invalidated in December 2002 and after years of litigation and the bank being inoperative, legal action was finally taken to close the institution for good.

There were several regulations introduced during 2013. One was the revised regulation on Capital Adequacy, which lowered the minimum required capital of uninsured foreign bank branches from five million down to two million; the caveat to this change is that the lowering of the capital requirement will be accompanied by a provision mandating the $2.0MM to be held locally.

[1] 48 USC Ch. 18 §1932. Extension of Compact of Free Association to Palau. (a) The interpretation of and United States Policy Regarding the Compact of Free Association set forth in section 1904 of this title shall apply to the Compact of Free Association with Palau. (b) The provisions of section 1905 of this title, except for subsection (i), section 1906 of this title, section 1910 of this title, and section 1911(a) and (d) of this title shall apply to Palau in the same manner and to the same extent as such sections apply to the Marshall Islands. (Pub. L. 99–658, title I, §102, Nov. 14, 1986, 100 Stat. 3675.)

48 USC Ch. 18 §1905. Supplemental provisions. (h) Continuing programs and laws. (2) Palau. Upon the effective date of the Compact, the laws of the United States generally applicable to the Trust Territory of the Pacific Islands shall continue to apply to the Republic of Palau and the Republic of Palau shall be eligible for such proportion of Federal assistance as it would otherwise have been eligible to receive under such laws prior to the effective date of the Compact, as provided in appropriation Acts or other Acts of Congress.

48 USC Ch. 18 §1911. Compensatory adjustments. (a) Additional programs and services. In addition to the programs and services set forth in Section 221 of the Compact, and pursuant to Section 224 of the Compact, the services and programs of the following U.S. agencies shall be made available to the Federated States of Micronesia and the Marshall Islands [including Palau as per §1932 (b)]: The Federal Deposit Insurance Corporation, Small Business Administration, Economic Development Administration, the Rural Electrification Administration, Job Partnership Training Act, Job Corps, and the programs and services of the Department of Commerce relating to tourism and to marine resource development.

[2] The Memorandum of Understanding between Bank of Guam and National Government was signed on April 1st, 2014.

Another was a new regulation concerning the licensing of alternative remittance systems. Others that were drafted and under review include regulation on bank's Customer Due Diligence programs and the FIC's Regulatory Response Policy.

Legislation impacting the financial sector that were adopted into law during the year include the controversial Remittance Tax and amendments to the Anti-Money Laundering and Proceeds of Crime Act (AMLPCA) [*pending final approval by the President of the Republic as of the date of this report*].

The Executive Commissioner and FIU Deputy Director Ismael Aguon participated in various conferences and workshops related to money laundering and FIU matters during 2013. Most of these trainings were funded by Taiwan (Republic of China). The APG invited FIU Deputy Director Aguon to attend and conduct presentations on case studies in Palau during an APG Typologies Training workshop in Brisbane, Australia. The two officials also attended the APG Annual Meeting in Beijing during in July as well as the APG Meeting in Seoul Korea in September. As a result of Palau's participation in these summits, the Palau FIU executed a Memorandum of Understanding with Korea to mutually cooperate in money laundering matters and capacity building. Additionally, FinCEN pledged assistance to source and potentially provide the Palau FIU with an electronic database and analysis IT system that will help in allowing the FIC/FIU to receive electronic filings of Suspicious Transactions Reports and Currency Transaction Reports.

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 has also been appointed Registrar of the Secured Transactions Registry.

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 RPPL 6-4, is located within the FIC and operates as an independent body with an operating budget that is provided by the FIC. The FIU is overseen by the Governing Board of the FIC and the Attorney General. Although the Attorney General serves as the Head of the FIU by law, the FIU Deputy Director manages the daily administration and operations of the agency. In August 2011, Mr. Ismael Aguon was formally appointed as Deputy Director of the FIU and since his appointment as Director of the Bureau of Public Safety, the Attorney General assigned Ms. Dolyn Tell, with the Transnational Crime Unit, as FIU Acting Deputy Director in June 2013.

Paperwork for announcing the Deputy Director post were submitted to Personnel in September 2013, however, a formal appointment has not been made as of the date of this report.

AUSTRAC and APG funded a regional training held in Palau from May 20 to 25, 2013, for FIUs and other law enforcement entities. Representatives from FSM, Marshalls, Guam, and Saipan attended. Acting FIU Deputy Director Tell attended an APG training in Mongolia in September 2013, which was sponsored by Taiwan.

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 and completion of the final part of FDIC examination training will be scheduled when funding is available. Other prior 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 as well as loan and financial statement analysis from PFTAC in conjunction with APRA and the Bank of International Settlements' Financial Stability Institute.

Sector Overview

The Financial Institutions Commission monitored and regulated five banks during the 2013 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 remains exempt from regulation and oversight pursuant to the statute. However, the FIC is aware of policymakers' intent to have it become a deposit-taking entity and be FIC regulated.

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. 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. The U.S. bank branches hold approximately 94% of the banking sector’s aggregate Net Loans and over 99% of the sector’s aggregate Total Deposits. [3]

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.

During the 2013 calendar year, there were few individuals/entities that expressed interest in establishing banking institutions in Palau, and the Commission did not receive any complete application packets for new banking licenses, and thus, none have been reviewed. 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.

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.[4] 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.

The FIC continues to regularly and consistently produce analysis reports for each licensed bank and branch, 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. The fourth Annual Banking Sector Report to the OEK was submitted on April 1st, 2013, for the calendar year ending December 31st, 2012.

[3] Based on figures reported for 2013 published by all banks. Historical data indicates that U.S. branch institutions 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. Aggregate figures used are derived from those published by all licensed banks.

[4] 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.

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 have enhanced the FIC's off-site monitoring program in terms of comparative analysis and performance tracking for each bank, banking group, and industry wide.

The FIC conducted onsite examinations of four out of the five licensed banks in Palau during the 2013 calendar year. 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.

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.

Lending Institutions Not Regulated by the FIC

As per the Financial Institutions Act, the National Development Bank of Palau (NDBP) and credit unions (with assets less than $500,000) are exempt from regulatory oversight and supervision by this agency. 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. The NDBP has stated its intentions to transition to a deposit-taking institution and will begin this process sometime within the near term.

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

CAPITAL ADEQUACY (Uninsured banks):

- **Aggregate capital for uninsured banking institutions continues its upward trend and increased by 8%, or $203M within the past year.** The strong earnings performance of one of these banks in particular has resulted in aggregate capital accretion for the uninsured banks, which individually are required to maintain at least one million dollars in capital.
- Capital appears to be at risk of falling below the statutory minimum level for one bank. 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 2013 calendar year. Although the two remaining uninsured banks in the sector remain in compliance with regulatory minimum capital ratios pursuant to statute and FIC prudential regulation PR-01; One bank**'s** level of capital, after onsite exam adjustments, fell below the statutory minimum required and offsite reports indicate that this bank may continue to be at risk of falling below the minimum capital required.

ASSET QUALITY:

- Quality of assets remains satisfactory for the banking sector.

  The quality of the sector's loan portfolio continues to be satisfactory with a Non Performing Loans to Total Loans ratio of 3.8%, stable compared to 3.6% at last year-end. The sector's Non Performing Loans (NPLs) went up by $71M, a nominal increase relative to the $3.2MM or 11.6% growth in Total Loans.
- Loan growth in 2013 is attributed to expansion in Unsecured consumer loans which comprise 86% of the sector's portfolio. Business loans (i.e. loans to Non-financial corporations) remain stable at $3.1MM and comprise the majority of Secured loans which have fallen from approximately $5MM to $4.3MM within the past year. There were $951M in loans written-off during the year and $345M in total recoveries on prior loan write-offs. Recoveries are 38% of total write-offs for the previous year. Altogether, these factors indicate that the sector is picking up lending activity and further lending growth may be expected with the anticipated expansions in the local operations of two U.S. branches.
  - *Insured banks* hold 96%, or $150MM, of the banking sector's total assets; 90% or $28MM of the sector's total loans, and 26%, or $277M of the sector's Non Performing Loans as of year-end.[5]
  - The ratio of Loans past due 360 days or more to Total Loans is minimal at 1.5%. Loans past due 360 days or more[6] fell 9%, or by $48M, from last year contributing to a slight decline from 1.6%.

[5] 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.

[6] *Insured banks* do not maintain on their books any loans past due 180 or more days as pursuant to their respective internal loan policies, thus the balance of these loans that are more than a year past due is attributable to Uninsured banks.

- ❖ **Provisions for Bad Loans remain adequate**. Aggregate Provisions for Bad Loans covers 213% of the sector's Non Performing Loans indicating that there is sufficient cushioning that well exceeds the potential for loan losses.

Due From Home Office balances of U.S. Branches comprise 75% of the banking sector's Total Assets. Approximately $117MM of the industry's $121MM in total cash and Due from Depository Institutions balances are demand deposits due from the Home Offices of U.S. FDIC-insured banks. Onsite exam findings show that **Insured banks generate yields higher than the average effective Federal Funds Rate.**

EARNINGS PERFORMANCE:

- ❖ **Earnings performance for the sector overall continues to be strong.** With the exception of two, banks generated profits during calendar year. Stable and growing profitability overall is expected with continued expansion in lending.
- ❖ Return on Assets (ROA) is stable although slightly declined from 1.63% last year to 1.45%. ROA for *Insured banks* has declined from 1.55% to 1.39%; as did ROA for *Uninsured banks* which is down from 3.65% to 3.07%. Earnings are slightly lower compared to last year because of higher Provisions for Bad Loans Expense.
  - Provisions for Bad Loans Expense is up, commensurate with the increase in loan volume, particularly in Past Due Loans. This has doubled the ratio of Provisions for Bad Loans Expense to Average Assets, from 0.23% to 0.58% in the past year, which has largely contributed to the decline in ROA.
  - Net Interest Margin is stable and growing. NIM has risen from 3.03% to 3.11% whereas average Yield on Loans has slightly declined from 11.64% last year to 11.57%, indicative of the expansion in lower yielding Unsecured consumer loans relative to higher yielding commercial loans.
  - The estimated average yield on aggregate balances Due from Home Office & Other branches of the *Insured group of banks*, at 0.88%, is notably above the Effective Federal Funds Rate average of 0.09% for 4th quarter 2013. These yields contributed to higher net interest margin.

Condensed Income & Expense Statement

Annualized (in U.S. '000s)	CYE2012			CYE2013		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Interest And Fee Income	3,668	497	4,165	4,029	527	4,556
Interest Expense	256	5	261	213	10	223
NET INTEREST INCOME	**3,412**	**492**	**3,904**	**3,816**	**517**	**4,333**
Provisions For Bad Loans Expense	**303**	**2**	**305**	**840**	**15**	**855**
NON-INTEREST INCOME	**1,076**	**8**	**1,084**	**1,067**	**8**	**1,075**
NON-INTEREST EXPENSE	**2,097**	**305**	**2,402**	**2,004**	**338**	**2,342**
NET INCOME (LOSS) BEFORE TAXES	2,088	193	2,281	2,039	172	2,211
Less: Applicable Income Taxes	115	9	124	83	11	94
Year-to-date Income (Loss)	**1,973**	**184**	**2,157**	**1,956**	**161**	**2,117**

LIQUIDITY ADEQUACY:

- ❖ **Liquidity in the sector continues to be strong.**
- ❖ The Liquidity Ratio calculated for the banking sector is stable at 83%. This means that for every dollar in short term liabilities, the banking sector maintained 83 cents in liquid assets. Liquid assets[7] grew by approximately $9.7MM, or 8.8% during the year, which is commensurate with the increase in cash and short term deposits.
- ❖ Even though local liquid assets (i.e. cash balances) aggregated for *Insured branch institutions* cover just 2.3% 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.
- ❖ One locally chartered bank maintains correspondent accounts at a U.S. bank branch, thus it's liquid assets remain fairly secure; however, one local bank is still unable to open a local correspondent account and maintains its liquid assets in uninsured banks abroad. Notwithstanding concerns with the security of 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 Customer Deposits for the banking sector grew 8.8%, or by approximately $11.9MM, during the year. Altogether, Savings and Demand deposits rose, whereas Time deposits fell by 3.6%, or by $399M, contributing to decline in Interest Expenses for the year.

The ratio of Total Deposits to Total Loans is stable although slightly declined from 483% to 471%. This ratio means that on average, for every dollar in loans, the sector maintains approximately $4.71 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, U.S. banks place unused excess deposits abroad with the U.S. Federal Reserve.

OTHER BANKING SECTOR STATISTICS

Remittances: **Remittance figures are for bank wire-transfers only and exclude a breakdown of remittances originated by non-bank financial institutions such as Western Union.**

- ❖ The banking sector took in approximately $94.3MM during calendar year 2013 and sent $105.2MM outside Palau. As expected, remittances to/from the U.S., Philippines, Japan, and Taiwan – our main trading partners – top the list. Remittances from Japan, the U.S., Taiwan and the Philippines together comprise 72%, or approximately $68MM, of total funds received. Approximately $82MM in funds were sent to these same countries during 2013, making up 78% of the banking sector's total outgoing remittances.
- ❖ Private sector non-financial corporations were shown to take in and send out the highest volume of remittances during the year, comprising 58%, or $55MM of total incoming remittances and 90%, or $95MM of total outgoing remittances.

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[7] 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.

- National Government, Non-profit Institutions, and Individuals netted incoming funds totaling approximately $29.3MM altogether. National Government brought in $23MM and sent out $3.8MM; Non-profits received $8.3MM and sent out just $25M; and Individuals received $8MM and remitted $6MM to recipients abroad.

Financial Access

- During calendar year 2013, both the number of depositors and number of deposit accounts increased, contributing to notable expansion in the sector's deposit base and resulting in the banking sector's asset growth. The number of Depositors went up from 20,800 to 21,379 and total deposit accounts grew from 22,308 to 22,968 – illustrating increases of 579 depositors or by 2.8% and 660 deposit accounts or by 3%, respectively.

- Similarly, the total number of borrowers as well as the number of loan accounts also rose during the past year. The number of borrowers went up by 891, or 18%; and total loan accounts increased by 883 or 17.7%. Total borrowers numbered 4,976 and loan accounts totaled 5,859 as of year-end.

Ratios & Summary Balance Sheet

KEY RATIOS (%)	CYE2012			CYE2013		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Total Capital to Total Assets	n.a.	49.00	n.a.	n.a.	50.71	n.a.
Tier 1 Leverage Capital Ratio	n.a.	45.45	n.a.	n.a.	47.70	n.a.
Tier 1 Risk Based Capital Ratio	n.a.	93.50	n.a.	n.a.	92.39	n.a.
Total Risk Based Capital Ratio	n.a.	102.65	n.a.	n.a.	99.95	n.a.
Non Performing Loans to Total Loans	0.77	26.44	3.57	1.12	25.94	3.83
Provisions for Bad Loans to NPLs	419.90	155.40	206.12	355.60	162.41	212.56
Net Income to Average Assets (ROA)	1.55	3.65	1.63	1.39	3.07	1.45
Net Interest Income to Average Earning Assets	2.75	13.55	3.03	2.81	14.30	3.11
Interest Margin to Gross Income	75.60	698.40	78.27	78.15	98.48	80.12
Non Interest Expense to Average Assets	1.65	6.09	1.82	1.42	6.44	1.60
Average Yield on Loans	11.10	15.97	11.64	11.13	15.43	11.57
Average Cost of Deposits	0.21	0.38	0.21	0.16	1.67	0.16
Liquidity Ratio (PR-10)	83.45	82.53	83.44	82.94	110.93	83.08
Cash Balances to Short Term Liabilities	1.80	19.44	1.91	2.34	18.07	2.42
Average Earning Assets to Average Assets	97.14	65.98	95.95	96.33	68.86	95.34
Net Loans to Total Assets	17.51	45.61	18.29	17.96	34.74	18.55
Customer Deposits to Total Loans	539.49	21.81	482.92	522.16	18.63	470.97

Summary Balance Sheet **Calendar Year to Date Amounts (in U.S. '000s)**	CYE2012			CYE2013		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Cash and Due from Other Banks	110,208	652	110,860	119,945	822	120,767
Other Assets	3,766	2,738	6,504	3,165	2,708	5,873
Net Loans	24,020	1,794	25,814	26,956	1,879	28,835
Gross Loans	*24,822*	*3,045*	*27,867*	*27,941*	*3,162*	*31,103*
Provisions for Bad Loans	*(802)*	*(1,251)*	*(2,053)*	*(985)*	*(1,283)*	*(2,268)*
Performing Loans	*24,631*	*2,240*	*26,871*	*27,664*	*2,372*	*30,036*
Non Performing Loans	*191*	*805*	*996*	*277*	*790*	*1,067*
******Loans over 360 days past due******	*NA*	*528*	*528*	*NA*	*480*	*480*
******Past Due Loans (includes NPLs)******	*873*	*1,036*	*1,909*	*1,246*	*969*	*2,215*
TOTAL ASSETS	**137,994**	**5,184**	**143,178**	**150,066**	**5,409**	**155,475**
Total Deposits	133,911	664	134,575	145,898	589	146,487
Demand/Checking	*61,437*	*0*	*61,437*	*63,963*	*0*	*63,963*
Savings	*58,930*	*647*	*59,577*	*69,224*	*569*	*69,793*
Time Deposits	*13,544*	*17*	*13,561*	*12,711*	*20*	*12,731*
Other Liabilities	2,110	1,980	4,090	2,212	2,077	4,289
TOTAL LIABILITIES	**136,021**	**2,644**	**138,665**	**148,110**	**2,666**	**150,776**
Issued and Fully Paid Up Common Stock	NA	3,965	3,965	NA	4,005	4,005
Paid-in Premium	NA	0	0	NA	0	0
Retained Profits (Losses)	1,973	(1,425)	548	1,956	(1,264)	692
Other Changes to Capital	0	0	0	0	2	2
TOTAL CAPITAL	**1,973**	**2,540**	**4,513**	**1,956**	**2,743**	**4,699**
TOTAL LIABILITIES & CAPITAL	**137,994**	**5,184**	**143,178**	**150,066**	**5,409**	**155,475**

APPENDIX

	As of Calendar Year-End 2013[1] (In U.S. Thousands)					As of Calendar Year-End 2013 (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	1,749	46,238	12,080	679	187	60,068	866	60,934
Net Loans	17,287	7,624	2,199	969	910	27,109	1,879	28,988
Other Assets[3]	58,704	77	32	638	106	58,813	744	59,557
TOTAL ASSETS	**77,740**	**53,939**	**14,311**	**2,286**	**1,203**	**145,990**	**3,489**	**149,479**
Deposits	77,520	53,929	14,295	484	105	145,744	589	146,333
Other Liabilities	22	9	75	153	4	107	157	264
TOTAL LIABILITIES	77,542	53,939	14,370	637	109	145,851	746	146,597
CAPITAL	198	0	(59)	1,649	1,094	139	2,743	2,882
TOTAL LIABILITIES & CAPITAL	**77,740**	**53,939**	**14,311**	**2,286**	**1,203**	**145,990**	**3,489**	**149,479**
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	2,804	1,121	205	336	154	4,130	490	4,620
Interest Expense	185	157	15	9	1	356	10	366
NET INTEREST INCOME	**2,619**	**964**	**191**	**309**	**153**	**3,774**	**462**	**4,236**
Non Interest Income	860	140	109	36	8	1,109	44	1,153
Non Interest Expense	1,682	804	359	166	177	2,845	343	3,188
Net Income (Loss) before Tax	1,797	300	(59)	179	(16)	2,038	163	2,201
Less: Applicable Net Income Tax	69	14	0	9	2	83	11	94
NET INCOME (LOSS) after Tax	**1,728**	**286**	**(59)**	**170**	**(18)**	**1,955**	**152**	**2,107**

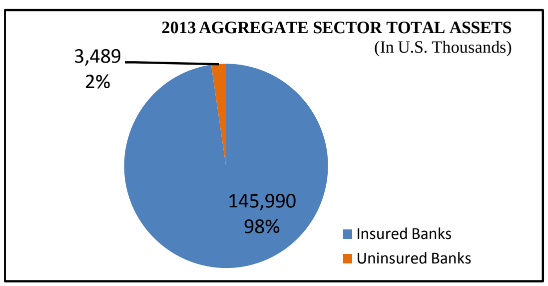
1/ All banks published Statements of Condition and Statements of Income (Loss) by March 1st 2014 with postings in bank lobbies

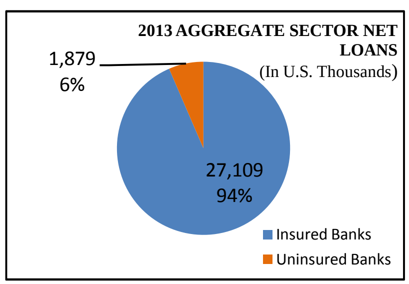
2/ BankPacific's figures are as of June 30, 2013, since the bank's fiscal year ends on June 30th.

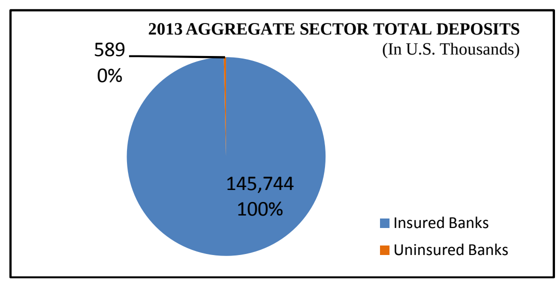
3/ includes fixed assets and accrued receivables other than loans; for Bank of Hawaii, Other Assets includes balances Due From Home Office

Key Ratios

Return on Total Assets	2.22%	0.53%	-0.41%	7.44%	-1.50%	1.34%	4.36%	1.41%
Return on Total Equity				10.31%	-1.65%		5.54%	
Capital to Average Assets				65.07%	99.50%		27.88%	
Liquid Assets to Total Deposits	2%	86%	85%	140%	178%	41%	147%	42%







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)

BANKING INSTITUTIONS OPERATING IN PALAU

As of January 2014

Bank Name	Home Country Charter	Date of Charter	License Status	Primary Regulator	Local Management	Address	Contact Information
Asia Pacific Commercial Bank	Palau	11/2/1999	Active	FIC	Mr. Mun Chee Woo, President Ms. Georgina Misajon, 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. Mathew 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: matthew.c.cruz@bankofguam.com
Bank of Hawaii	Hawaii	9/18/1961	Active	U.S. Federal Reserve	Mr. Richard Ziegler, Branch 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	7/11/1995	Active	U.S. FDIC	Mr. Joseph Koshiba, Bank 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	5/16/1995	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