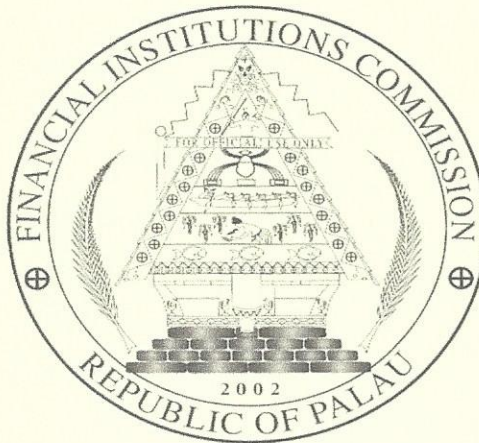


2017 Annual Banking Sector Report

FINANCIAL INSTITUTIONS COMMISSION of the REPUBLIC OF PALAU



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


G. Semdiu Decherong
Executive Commissioner

June 5, 2018
Date



Republic of Palau
Financial Institutions Commission

Calendar Year 2017
Annual Report of the Palau Banking Sector

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SUMMARY INDUSTRY ASSESSMENT

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

- Total Assets of all licensed banks grew 3% during the year as a result of sustained growth in customer deposits.
- Asset quality indicators remain satisfactory. The industry ratio of Non-Performing Loans (NPLs) to Total Loans remains low and fell slightly from 0.78% to 0.61% during the year. The volume of outstanding loans increased by 13% or approximately \$4.2MM 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 slightly increased from 1.50% to 1.55%. Relative stability is maintained as a result of asset growth. Also contributing to stable profits 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 \$250MM of the sector's \$291MM total assets are liquid assets as defined by FIC regulation PR-10. At year-end, there was approximately ninety-one 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 5% in 2017. Uninsured locally chartered banks demonstrate the desire to maintain capital growth although the rate of capital growth has contracted compared to the prior year. The slowdown in the sector's expansion correlates with reduction in tourism numbers and related economic activity.
- U.S. bank branches remain dominant in the industry and altogether hold 98% of the sector's assets as of December 31, 2017. All U.S. banks operating in Palau are in good standing with their primary regulators in the U.S., maintain access to U.S. capital markets, and maintain Palau's excess liquidity in relatively safe securities and investments 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: for the purposes of this report, numbers accompanied by the Roman numeral "M" represent figures in thousands, and "MM" represents figures in millions; "sector" and "industry" are used interchangeably in this report but both refer to licensed deposit-taking institutions]

NEW DEVELOPMENTS

APG Mutual Evaluation of the Republic of Palau

In 2017, the APG¹ conducted a Mutual Evaluation of the Republic of Palau's compliance with the FATF 40 Recommendations². A team of five "experts" performed an on-site visit from November 20-30, 2017, and their assessment process was led by two members of the APG Secretariat. The Evaluation Team conducted a series of meetings with various stakeholders, including government agencies, independent bodies, financial institutions, and non-bank financial businesses. The aim of these meetings was to assess Palau's laws, regulations, policies and practices when it comes to the prevention of money laundering and terrorism financing. Included in this assessment was an evaluation of effectiveness, i.e. how Palau goes about implementing existing laws and other legal instruments in its efforts to detect and deter money laundering and terrorism financing. A report³ of the findings and recommendations stemming from the Mutual Evaluation will be presented at the APG's Annual Plenary, which will be held in Kathmandu, Nepal from July 21-27, 2018. After the presentation and adoption of Palau's final Mutual Evaluation Report to the APG, the document will be made available to the public. The last Mutual Evaluation of Palau was conducted in 2008.

Strategic Planning for the FIC & FIU

In September 2017, the FIC and the FIU initiated the development of an overarching strategic plan, including holding a two day strategic planning retreat that resulted in revamping the agencies' vision, core values, and targeted objectives. Both agencies continue to work on action plans for implementation of the Board's adopted long-term, medium-term and short-term goals.

Governing Board of Commissioners

There are two vacant seats on the FIC Governing Board of Commissioners that have yet to be filled. The three-year tenure of Mr. Melwert Kikuo on the FIC Board ended in October 2017 and his appointment was not renewed. There was already a vacancy on the Board left when former FIC Chairman Okada Tachitong ended his term in May 2015. Mr. Nick Ngwal and Mr. Secilil Eldebechel were nominated and appointed to the Board by the President during the year but did not garner enough votes from the Senate to be confirmed. Mr. Tutii Chilton, whose current term ends in 2019, remains the Chairperson of the FIC Board. Ms. Uroi Salii serves as Vice Chairperson, and Mrs. Jennifer Koskelin-Gibbons is the third voting member on the Board. The terms of both Ms. Salii and Mrs. Koskelin-Gibbons will end in October 2018.

With an established quorum currently consisting of three voting Board members, the departure of any existing voting member on the FIC Board without replacement shall render the Commission unable to take regulatory

¹ In February 1997, the Asia/Pacific Group on Money Laundering (APG) was officially established as an autonomous regional anti-money laundering body by unanimous agreement among 13 original founding member countries. A Secretariat was established in Sydney, Australia to serve as the focal point for APG activities. The APG has since grown considerably and is part of a global network of similar bodies, referred to as Financial Action Task Force-Style Regional Bodies (FSRBs). The APG is the largest in terms of membership numbers and geographical size. Some of the key international organizations that support the APG include the International Monetary Fund, World Bank, OECD, United Nations Office on Drugs and Crime, the UN's Counter Terrorism Executive Directorate, Asian Development Bank, Commonwealth Secretariat, INTERPOL and the Egmont Group of Financial Intelligence Units.

² The Financial Action Task Force (FATF) is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction. The international standards against money laundering and the financing of terrorism/proliferation are contained in the 40 Recommendations of the Financial Action Task Force (FATF). The 40 Recommendations provide a complete set of counter-measures against money laundering (ML) covering the criminal justice system and law enforcement, the financial system and its regulation, and international co-operation. They have been recognized, endorsed, or adopted by many international bodies.

³ Mutual Evaluation Reports are published on the APG website <http://www.apgml.org/documents/>

action against any licensed bank and unable to act upon any license application received. The FIC has corresponded with the President's Office including providing lists of potential nominees; however, there has been little to no progress in terms of having new Board members appointed and confirmed.

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, and are open to the public.

New Banking License Applications

During the 2017 calendar year, the Commission reviewed four application packets for new banking licenses and the Board rendered a license decision relating to three of those applicants. As a result of the Board's declinations, no new bank licenses were issued during the year. 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.

In 2017, there were a number of informal inquiries into obtaining a license from the FIC, although no other complete applications pertaining thereto were received.

IMF, PFTAC and the AFSPC

PFTAC workshop - North Pacific Region

PFTAC hosted a workshop on Guam in May 2017 for financial sector supervisors from the North Pacific Region, including Palau, the FSM, and RMI. The delegation from Palau that attended consisted of the Executive Commissioner, the FIC Administrative Officer, and the FIC Board's Ex-Officio member. The focus of the workshop was on drafting language to enhance financial institutions legislation in each respective jurisdiction. Those areas of particular interest include sections of law pertaining to technology-based or electronic banking, the supervision of non-banks, the issuance of different classes of financial institution licenses, and digital currency, among others. PFTAC committed to providing technical assistance aimed at updating and improving Palau's Financial Institutions Act and prudential regulations, and following the workshop, proposed a timeline for technical assistance during 2018.

Annual AFSPC Meeting

Cook Islands hosted the 2017 annual AFSPC⁴ meeting in Rarotonga from August 14-18. Thirteen jurisdictions, including New Zealand and Australia, reported on the current condition of their respective financial sectors. Following the annual meeting of financial sector supervisors, several workshop sessions were facilitated by IMF banking regulation experts focused on resolving problem banks. There were also presentations and high level discussions on Fintech⁵, cryptocurrency, and other supervisory developments in the region.

Financial Intelligence Unit (FIU)

National Risk Assessment

The FIU completed work on Palau's National Risk Assessment (NRA), a process involving identifying areas of vulnerability to money laundering and terrorism financing in the country. A questionnaire was disseminated

⁴ Association of Financial Supervisors of Pacific Countries (AFSPC) is the Pacific technical assistance arm of the International Monetary Fund; the FIC has been a member of this regional body since 2003.

⁵ Fintech is a term that refers to computer programs and other technology used to support or enable banking and/or financial services.

including comprehensive guide for the NRA, both developed by the FIU to collect data from relevant agencies such as Customs, Immigration, Tax & Revenue, Foreign Investment Board, etc. An NRA has never been conducted for Palau and the FIU initiative helped the country to garner a greater understanding of its risks and how Palau can better prepare to meet its obligations under the FATF recommendations and prepare the country for the Mutual Evaluation performed by the Asia Pacific Group on money laundering. The National Risk Assessment was signed by Vice President and Minister of Justice Raynold Oilouch.

Enhanced Database for the FIU

The FIU hired an intern who worked with the agency over an eight week period from July to August 2017. A student from Carnegie Mellon University assisted the FIU develop and launch an online reporting platform for all regulated financial entities to use in the submission of Currency Transactions Reports and Suspicious Transactions Reports. The new and improved database has provided the agency with enhanced capacity to conduct analysis on information received.

Legislation & Regulations

The FIU issued AML Regulations that became effective last year whereas the FIC still has proposed regulations pending review and approval, such as the Alternative Money Remitters' Licensing regulations and Customer Due Diligence regulations.

A delegation of three from the FIC attended a PFTAC workshop on Guam held in June 2017. The focus of the workshop was to review existing banking legislation for the three North Pacific jurisdictions (i.e. Palau, FSM, and RMI) and identify sections of law that need updating. With PFTAC's technical assistance, the FIC will be drafting amendments to the Financial Institutions Act to address such matters as fintech and off-shore banking, among others.

Any proposed regulations and legislative amendments shall go through the Administrative Procedures Act process as appropriate.

BACKGROUND & GENERAL OVERVIEW

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

Structure of the Commission

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

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

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

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

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

Anti-Money Laundering

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

Financial Intelligence Unit

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

Internal and External Cooperation

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

Training and Technical Assistance

The Commission receives extensive technical training and support from international organizations and supervisory agencies such as the International Monetary Fund (IMF), the Pacific Financial Technical Assistance Centre (PFTAC), and recently, the U.S. FDIC. The Bank Examiner has successfully completed the all phases of the FDIC's series of examination schools. FDIC examination training 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. The Executive Commissioner has completed the first three phases of the U.S. FDIC's examination school.

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 as well as IFRS 9 and financial reporting standards from the IMF's Singapore Training Institute.

Sector Overview

The Financial Institutions Commission monitored and regulated five banks during the 2017 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, 2017, the U.S. bank branches hold approximately 91% of the banking sector's aggregate Loans and 99.8% of the sector's aggregate Total Deposits.⁶

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.⁷ 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 ninth annual report published by the FIC. Last year's Annual Banking Sector Report was delivered to the OEK on May 29, 2017. Prior year reports submitted to the OEK are available through the FIC's official website at <http://www.ropfic.org/>

The FIC conducted a total of three onsite examinations during the 2017 calendar year. Examinations were conducted on Asia Pacific Commercial Bank and the Koror branch of BankPacific, Ltd. One bank was examined twice within the year to follow up on ongoing matters.

⁶ 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.

⁷ 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 CAMELS⁸ 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 on the conduct of onsite examinations and off-site monitoring. In fact, the Bank Examiner successfully completed the U.S. FDIC's Examination Management School in November 2016, a requisite achievement to earn the Commissioned Examiner status for U.S. bank examiners, and is currently the only examiner in the Pacific who holds this distinction. The Bank Examiner has since undertaken the role of Examiner-In-Charge for the agency and solely conducts all onsite bank examinations.

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.

⁸ The CAMELS rating system is a risk-based supervisory approach where onsite examinations are broken down into six components, namely "Capital adequacy", "Asset quality", "Management", "Earnings performance", "Liquidity adequacy", and "Sensitivity to market risk". Each component is evaluated during an onsite examination and assigned a risk rating based on qualitative and quantitative factors reviewed.

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

BANKING SECTOR INDICATORS

Capital, Assets, Earnings, & Liquidity

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

CAPITAL ADEQUACY (Uninsured banks):

- ❖ **Aggregate capital for uninsured banking institutions continues its upward trend and increased by 5%, or \$186M, during the year.** The consistent earnings performance of one of the two locally chartered banks has resulted in aggregate capital accretion for the uninsured banks, which individually are required to maintain at least one million U.S. dollars in capital.
- ❖ The FIC monitors Uninsured banks to ensure capital levels are maintained above statutory minimum requirements and has verified each bank's capital position during onsite examinations conducted during the 2016 and 2017 calendar years. As of the calendar year ended December 31, 2017, 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. Assets continue to grow as a result of sustained deposit growth, and increased from approximately \$283MM to \$291MM during 2017.
The quality of the sector's loan portfolio continues to be satisfactory. The ratio of Non Performing Loans to Total Loans remains nominal and declined from 0.78% at prior year to 0.61%. The total volume of Non Performing Loans (NPLs) fell 11% or by \$28M during 2017. The volume of NPLs at calendar year-end 2017 is approximately \$217M relative to the \$35,770M in aggregate loans for the banking sector.
- ❖ Total loans increased by 13%, or \$4.2MM, during 2017 as a result of notable growth in aggregate commercial loans. Business loans (i.e. loans to Non-financial corporations) expanded by approximately \$5.3MM, more than doubling compared to the prior year. Unsecured consumer loans, which comprise 79% of the sector's portfolio, fell by 4%, or approximately \$1.1MM. Growth in secured loans is commensurate with increase in the volume of commercial loans, although usage of the Secured Transactions Registry has not correlated with expansion in secured lending, despite the registry having been established for some time now. 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; 91% or approximately \$32MM of the sector's total loans; and 63%, or approximately \$136M of the sector's Non Performing Loans as of year-end.⁹
- ❖ **Provisions for Bad Loans remain adequate for all commercial banks.** Aggregate Provisions for Bad Loans are six 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 2.5%. Recoveries on loans written-off is strong and during 2017, banks collected approximately 48% of the previous year's level of charge-offs.

⁹ 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.

- ❖ **Due From Home Office balances of U.S. Branches** comprise 85% of the banking sector's Total Assets. Approximately \$247MM of the industry's \$250MM 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**. This is deemed by the FIC to be a fair return on Palau excess depositor funds used for investment abroad. Excess funds from Palau are pooled with other bank funds and invested in U.S. securities or used to lend abroad. Records reviewed during onsite examinations demonstrate that the U.S. banks operating in Palau are placing funds in relatively safe investments such as U.S. Treasury and Agency securities.

EARNINGS PERFORMANCE:

- ❖ **Earnings performance for the sector continues to be satisfactory.** Most banks generated profits during the calendar year. Stability in earnings is expected to be maintained and there continues to be potential to expand lending locally given sustained growth in excess liquidity.
 - Return on Assets (ROA) for the overall sector has increased from 1.50% to 1.55% during 2017—an increase commensurate with expansion in lending relative to growth in assets. Interest rates on deposits are maintained between 0.01% and 2%. Lending rates remain capped at 18% due to standing legislation although variable rates have remained relatively unchanged and range from one to four percent above the Prime rate. Historical figures show that the spread between yield on loans and cost of deposits has narrowed gradually but remains at around 10%. Unsecured consumer loan fixed rates start from 10% 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)¹⁰ increased from 2.38% to 2.59%. On the other hand, Yield on Loans has slightly declined from 10.97% to 10.47% compared to prior year-end, suggesting that the growth in asset yields outpaced the rate of growth in earning assets. Although loan rates remained relatively unchanged, income on excess liquidity invested abroad by the three large U.S. bank branches significantly increased overall.
 - The yield on local branch balances maintained at U.S. bank Home Offices indicate strong earnings from the investment of excess funds outside Palau. Income earned from balances at U.S. banks' Home Offices comprised 42% of the industry's gross income for the year, up from 36% last year. The estimated average yield on aggregate balances Due from Home Office & Other branches of the *Insured group of banks* has increased from 1.11% last year-end to 1.45%. 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 2017 was 1%.

Condensed Income & Expense Statement

Annualized (in U.S. '000s)	CYE2016			CYE2017		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Interest And Fee Income	5,958	547	6,505	6,880	574	7,454
Interest Expense	198	1	199	228	6	234
NET INTEREST INCOME	5,760	546	6,306	6,652	568	7,220
Provisions For Bad Loans Expense	247	24	271	473	3	476
NON-INTEREST INCOME	927	6	933	984	2	986
NON-INTEREST EXPENSE	2,304	438	2,742	2,474	402	2,876
NET INCOME (LOSS) BEFORE TAXES	4,136	90	4,226	4,689	165	4,854
Less: Applicable Income Taxes	143	11	154	174	12	186
Year-to-date Income (Loss)	3,993	79	4,072	4,515	153	4,668

¹⁰ 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 industry's Liquidity Ratio, at 91%, continues to be stable. This means that for every dollar in short term liabilities, the banking sector maintained 91 cents in liquid assets. Liquid assets¹¹ grew by approximately \$2.4MM, or 1% during 2017, which is commensurate with the increase in demand and short term deposits.
- ❖ Even though local liquidity (i.e. cash balances) aggregated for *Insured branch institutions* cover just 0.52% 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 continue to 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 equity capital to generate earnings.
- ❖ **All banks in the sector demonstrate continued ability to meet depositor demands.**
- ❖ Total Deposits for the banking sector grew 2%, or by approximately \$6.4MM, during the calendar year and totaled approximately \$278MM at year-end. The deposits of national government and individuals led deposit growth, having experienced \$3.9MM (or 6%) and \$3.2MM (or 4%), respectively, during the year. Similarly, the deposits of Non-financial Corporations and State Governments increased by \$1.4MM (or 1%) and \$1.2MM (or 4%), respectively, during 2017.

The ratio of Total Deposits to Total Loans is still high, although dropped from 861% to 778%, commensurate with loan growth outpacing deposit growth. This ratio means that on average, for every dollar in loans, the sector maintains approximately \$7.78 in deposits. 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 beyond what has been achieved in recent years. 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. However, Bank of Guam's innovative lending strategies have led to increased commercial lending activity and may signify enhanced opportunities to access credit locally.

OTHER BANKING SECTOR STATISTICS

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

More funds continue to be sent outside Palau than are received through local banks and branches of U.S. banks.

- ❖ **A total of approximately \$119MM came into Palau and approximately \$136.5MM was sent abroad during the 2017 calendar year** through the U.S. bank branches. Wire transfers to and from the U.S., Japan, and Taiwan – our main trading partners – top the list.
- ❖ Remittances received by bank customers in Palau from those three above listed countries together comprise 72%, or approximately \$85.7MM, of total funds received during 2017. Of the total Outgoing wire transfers, approximately \$79.5MM, or 58%, were sent to those same three countries listed above. Another \$20MM and \$14MM were sent via wire transactions to the Philippines and China, respectively. Wires to the Philippines and China have increased exponentially in recent years due to increased labor and trade activity with citizens of these countries residing in Palau and working in tourism and retail sectors.
- ❖ *See appendix with remittance tables and graphs for more information*

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.

¹¹ 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 declined compared to the prior year, despite further expansion in the sector's volume of funds held in deposit accounts and slight increase in the sum of the total number of deposit accounts reported. The aggregate total number of Depositors¹² was reduced from 19,761 to 19,534. 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 6,511—down from 6,587 last year. The total number of Deposit Accounts also declined. The sum of all deposit accounts fell from 22,176 to 21,123—a decline of 1,053 accounts.
- ❖ The aggregate number of Borrowers declined from 5,810 to 5,465, and the number of Loan Accounts fell from 6,354 to 5,971 during the 2017 calendar year. Given that one large commercial loan issued during the year primarily contributed to expansion in the volume of credit outstanding in the sector, the reduction in borrowers and loan accounts reported for the year is commensurate with reduction in consumer lending. For instance, the volume of consumer loans fell 3% or by approximately \$900M compared to the previous year.

¹² Reported number of Depositors for each licensed bank added all together

RATIOS & SUMMARY BALANCE SHEET

KEY RATIOS (%)	CYE2016			CYE2017		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Total Capital to Total Assets	n.a.	55.84	n.a.	n.a.	59.30	n.a.
Tier 1 Leverage Capital Ratio	n.a.	54.48	n.a.	n.a.	56.79	n.a.
Tier 1 Risk Based Capital Ratio	n.a.	87.61	n.a.	n.a.	86.44	n.a.
Total Risk Based Capital Ratio	n.a.	91.29	n.a.	n.a.	91.68	n.a.
Non Performing Loans to Total Loans	0.67	1.85	0.78	1.59	2.49	2.81
Provisions for Bad Loans to NPLs	406.77	1,450.94	632.65	0.42	832.10	0.61
Net Income to Average Assets (ROA)	1.50	1.36	1.50	509.56	2.57	629.95
Net Int Inc to Avg Earning Assets (NIM)	2.20	14.40	2.38	1.62	14.50	1.64
Average Yield on Loans	10.39	16.65	10.97	2.42	17.69	2.59
Average Cost of Deposits	0.08	0.17	0.08	9.79	1.12	10.47
Liquidity Ratio (PR-10)	91.80	163.58	91.97	0.08	153.00	0.09
Net Loans to Total Assets	10.06	36.04	10.60	90.54	42.00	90.68
Customer Deposits to Total Loans	945.05	20.57	861.04	11.19	17.63	11.84
Cash Balances to Short Term Liabilities	0.75	19.97	0.80	0.52	16.72	0.56

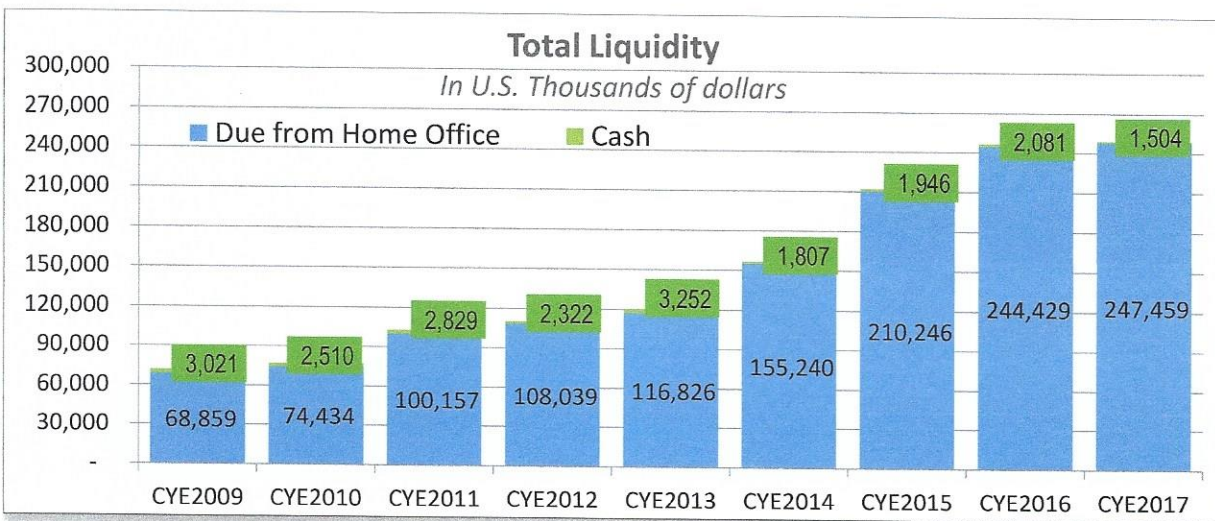
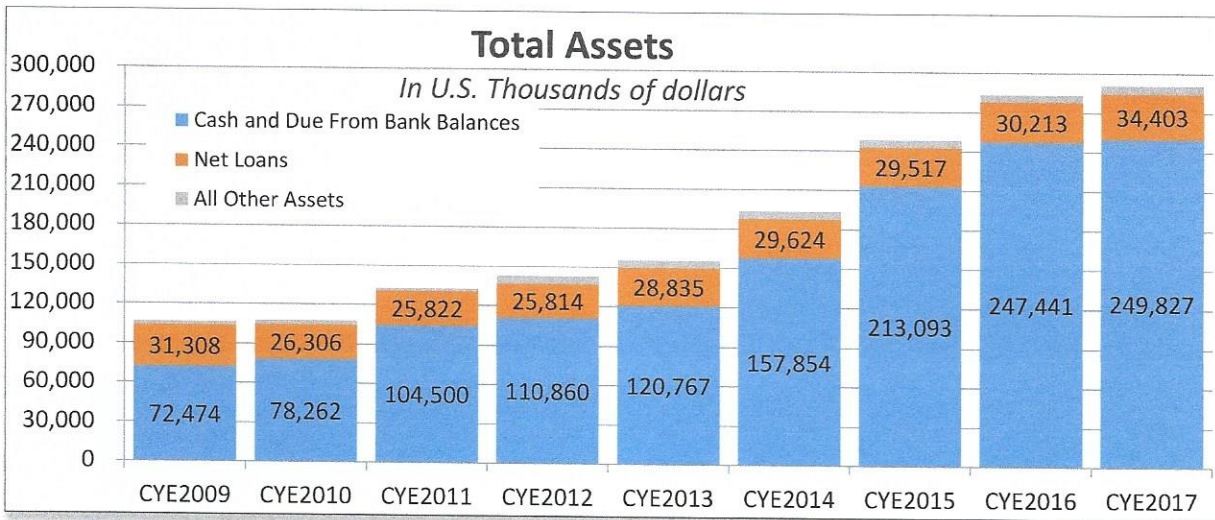
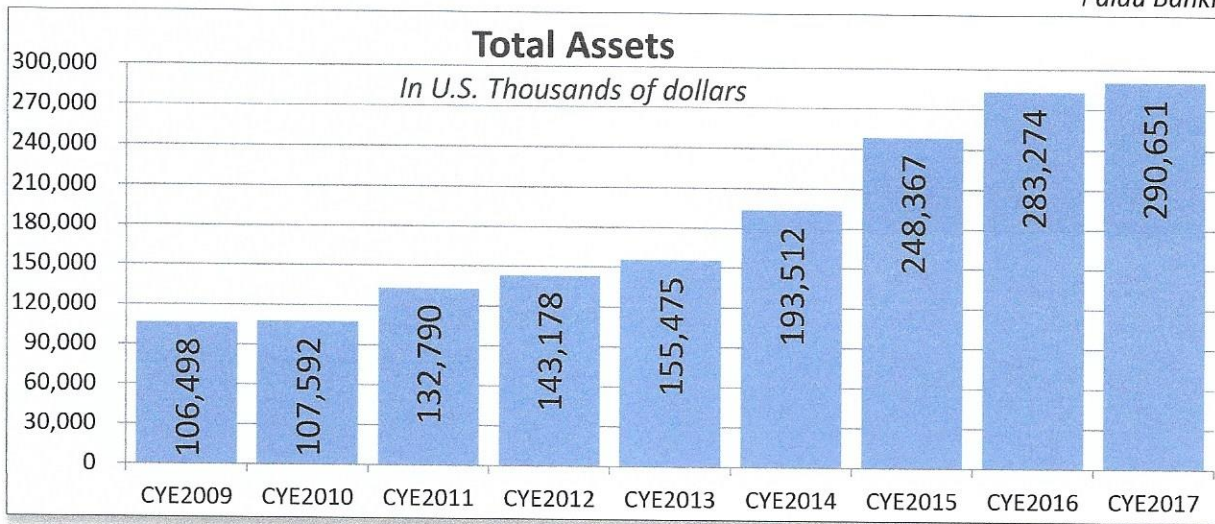
Summary Balance Sheet Calendar Year to Date Amounts (in U.S. '000s)	CYE2016			CYE2017		
	Insured	Uninsured	All Banks	Insured	Uninsured	All Banks
Cash and Due from Other Banks	246,381	1,060	247,441	248,857	970	249,827
Net Loans	27,914	2,099	30,013	31,826	2,577	34,403
<i>Gross Loans</i>	28,695	2,868	31,563	32,519	3,251	35,770
<i>Provisions for Bad Loans</i>	(781)	(769)	(1,550)	(693)	(674)	(1,367)
<i>Performing Loans</i>	28,503	2,815	31,318	32,383	3,170	35,553
<i>Non Performing Loans</i>	192	53	245	136	81	217
<i>****Past Due Loans (includes NPLs)****</i>	840	243	1,083	693	254	947
Other Assets	3,155	2,665	5,820	3,833	2,588	6,421
TOTAL ASSETS	277,450	5,824	283,274	284,516	6,135	290,651
Total Deposits	271,181	590	271,771	277,582	573	278,155
<i>Demand/Checking</i>	103,950	0	103,950	97,192	0	97,192
<i>Savings</i>	153,165	576	153,741	165,004	563	165,567
<i>Time Deposits</i>	14,066	14	14,080	15,386	10	15,396
Other Liabilities	2,276	1,982	4,258	2,419	1,924	4,343
TOTAL LIABILITIES	273,457	2,572	276,029	280,001	2,497	282,498
Issued and Fully Paid Up Common Stock	0	4,105	4,105	0	4,135	4,135
Paid-in Premium	0	0	0	0	0	0
Retained Profits (Losses)	3,993	(853)	3,140	4,515	(498)	4,017
Other Changes to Capital	0	0	0	0	1	1
TOTAL CAPITAL	3,993	3,252	7,245	4,515	3,638	8,153
TOTAL LIABILITIES & CAPITAL	277,450	5,824	283,274	284,516	6,135	290,651

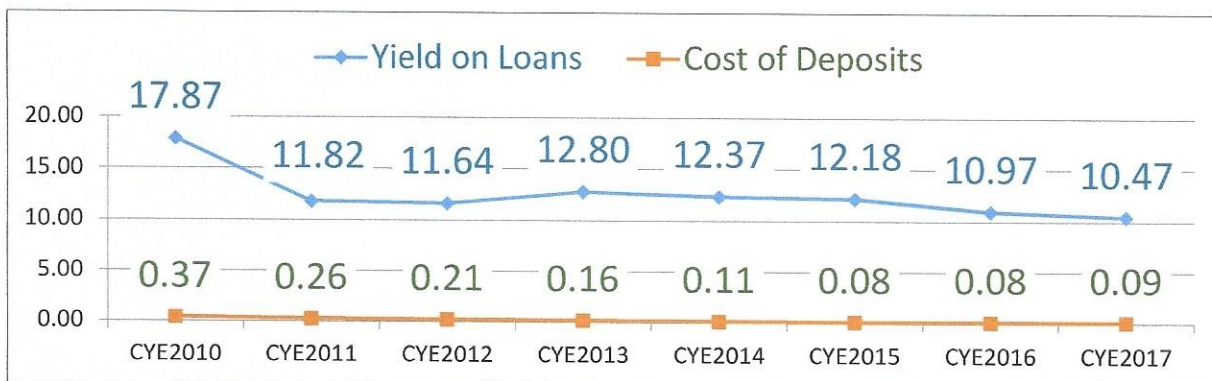
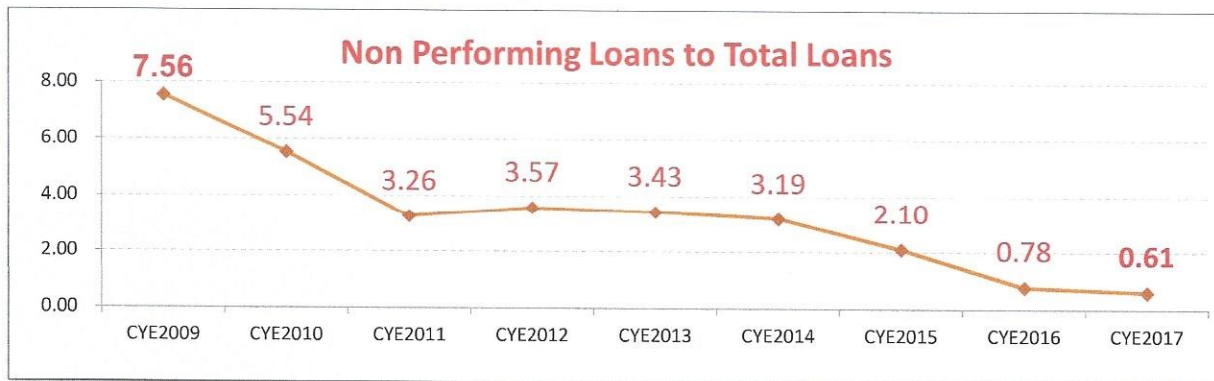
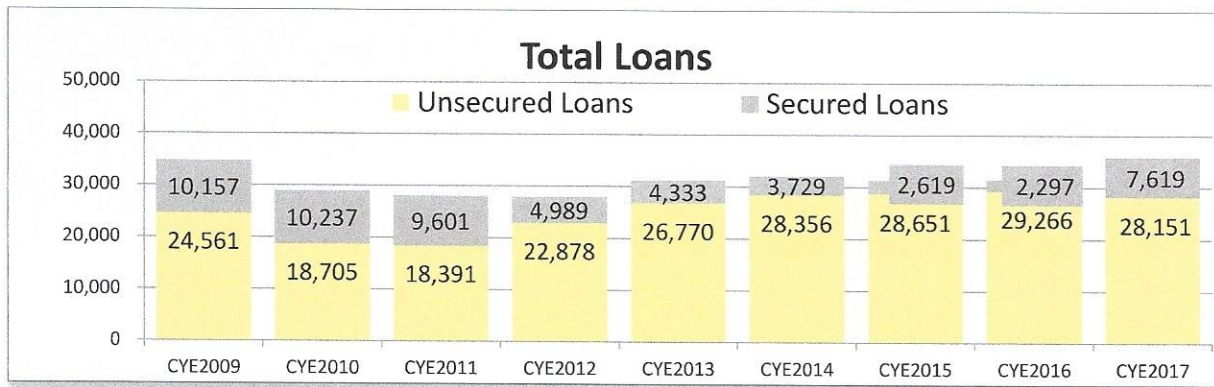
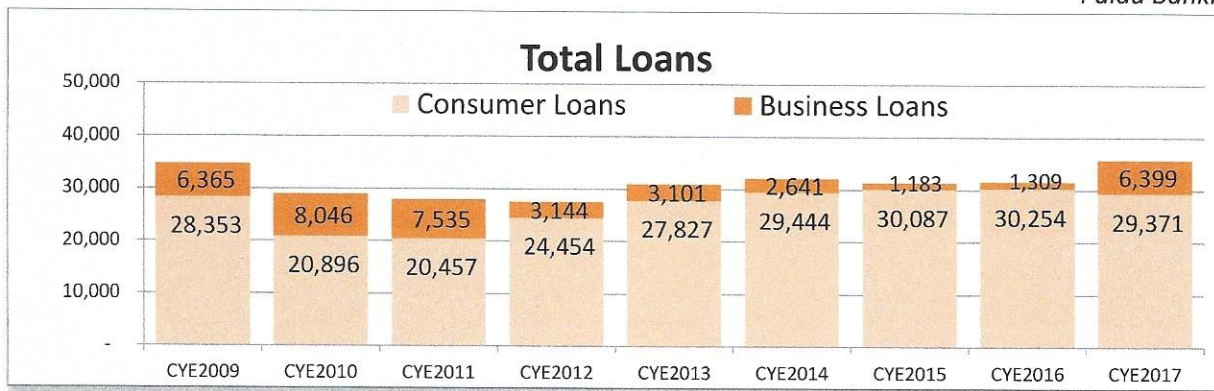
APPENDIX

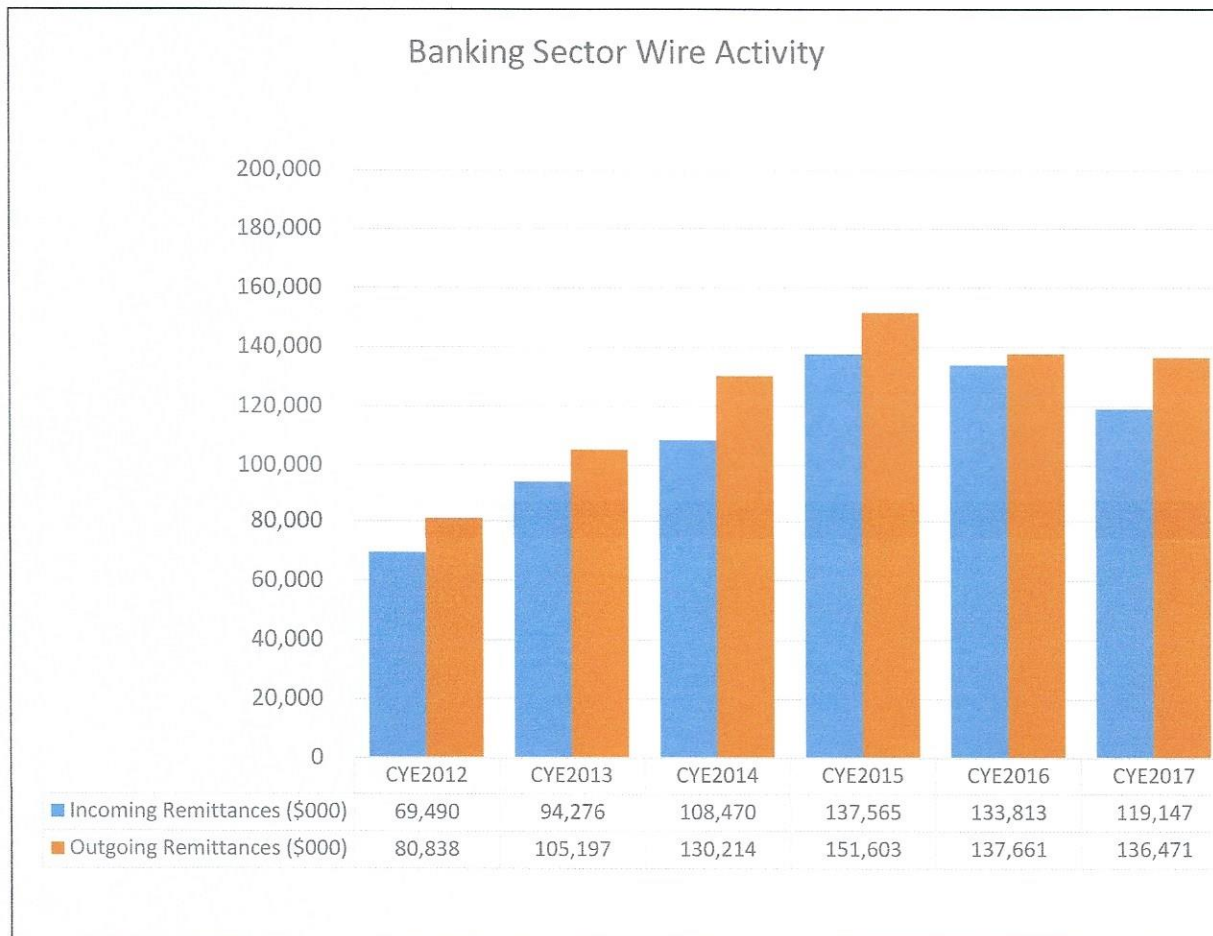
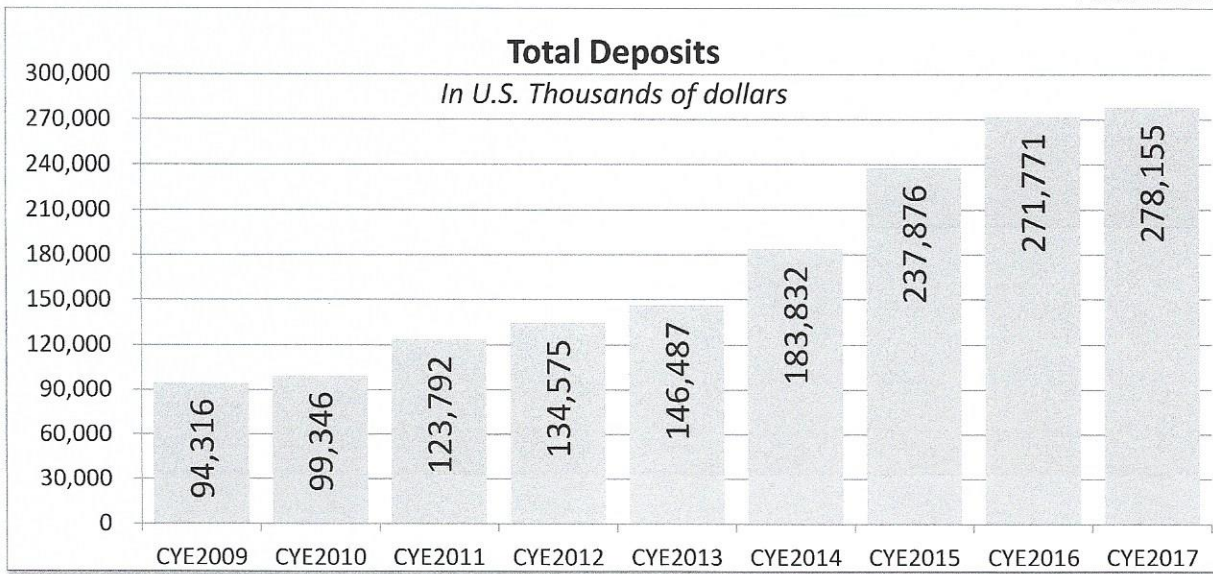
BANKING INSTITUTIONS OPERATING IN PALAU

As of January 2018

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, <i>Bank Manager</i>	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, <i>VP/Branch Manager</i>	Digeronger, 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, <i>VP/Palau Island Manager</i>	Medalau, Koror P.O. Box 340 Republic of Palau 96940 http://www.boh.com	Tel. 488-2602 / 488-3285 Email: Christina.Michelsen@boh.com
BankPacific, Ltd.	Guam	7/28/1995	Active	U.S. FDIC	Mr. Joseph Koshiba, <i>Branch Manager</i>	Digeronger, Koror P.O. Box 1000 Republic of Palau 96940 http://www.bankpacific.com	Tel. 488-5635 / 488-5226 Email: jeek@bankpacific.com
Palau Investment Bank formerly "Palau Construction Bank"	Palau	7/28/1995	Active	FIC	Ms. Lucia Tellei, <i>General Manager</i>	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	<i>pending</i>	FIC	Ms. Claire Harvey, <i>President</i> Ms. Karla West, <i>Operations Manager</i>	Ngekitib, Arai P.O. Box Republic of Palau 96940	Tel. 587-2578 Email: charvey@ndbp.com , or kwest@ndbp.com







Calendar Year 2017 Report on Palau Banks' Remittance Activity

<i>In U.S. Thousands of Dollars</i>				
By Country of Origin, Country of Destination	CY2016	CY2017	\$ Change	% Change
Aggregate Incoming Wires	133,813	119,147	(14,666)	-11%
United States	44,853	43,357	(1,496)	-3%
Taiwan	36,649	14,581	(22,068)	-60%
Japan	23,823	27,796	3,973	17%
China	544	5,388	4,844	890%
All Others*	27,944	28,025	81	0.3%
Aggregate Outgoing Wires	137,661	136,471	(1,190)	-1%
United States	49,481	48,195	(1,286)	-3%
Taiwan	15,911	10,363	(5,548)	-35%
Japan	19,945	20,925	980	5%
Philippines	14,387	20,724	6,337	44%
China	1,843	14,661	12,818	695%
All Others**	36,094	21,603	(14,491)	-40%

*includes Australia, New Zealand, Philippines, and countries unspecified under 'All Others'

**includes Australia, New Zealand, and countries unspecified under 'All Others'

<i>In U.S. Thousands of Dollars</i>				
By Economic Sector	CY2016	CY2017	\$ Change	% Change
Aggregate Incoming Wires	133,813	119,147	(14,666)	-11%
Non-financial Corporations	43,325	63,676	(7,261)	-10%
National Government	70,937	38,523	(4,802)	-11%
Individuals	5,994	6,644	650	11%
Non-profit Institutions	13,441	9,721	(3,720)	-28%
All Other Sectors*	116	583	467	403%
Aggregate Outgoing Wires	137,661	136,471	(1,190)	-1%
Non-financial Corporations	10,472	114,866	(7,572)	-6%
National Government	122,438	11,151	679	6%
Individuals	3,467	6,118	2,651	76%
Non-profit Institutions	45	1,218	1,173	2607%
State Governments	1,136	503	(633)	-56%
All Other Sectors*	103	2,615	2,512	2439%

*includes domestic non-bank financial corporations and State Governments

