Financial Stability Report

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CENTRAL BANK OF SOLOMON ISLANDS

FINANCIAL STABILITY REPORT

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The report is published half yearly, and all enquiries pertaining to the FSR should be addressed to:

The Chief Manager
Financial Market Supervision Department
Central Bank of Solomon Islands
P O Box 634
Honiara
Solomon Islands

Telephone: (677) 21791/21792/21793

Facsimile: (677) 23513

SWIFT BIC: CBSISBSB

Email: info@cbsi.com.sb
Website: www.cbsi.com.sb

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This report is based on unaudited and provisional data of banks and non-bank financial institutions available up to December 31, 2017 unless stated otherwise in the relevant chapters/sections.

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GOVERNOR'S FOREWORD

Gov. Denton Rarawa

I am honored to present the second edition of the Financial Stability Report (FSR) of the Central Bank of Solomon Islands (CBSI).

This second report presents the CBSI's assessment of the vulnerabilities, risks, and the resilience of the Solomon Islands financial system, to sustain its financial intermediation role in the economy. The FSR also highlights the surveillance and supervisory measures undertaken by the CBSI to eliminate or minimize such vulnerabilities and risks to ensure continued safety and soundness of the financial system and its institutions.

Since the issue of the last FSR, new vulnerabilities and risks to the financial system have emerged. These includes the marginalization of one financial institution from the global financial system due to de-risking issues, the entry of demonetized currencies and counterfeit notes into the system, and the emergence of cyber security risks. In response to these emerging vulnerabilities and risks, the CBSI is working closely and persistently with relevant stakeholders to find solutions to these matters. In particular, on demonetized currencies, the CBSI directed licensed financial institutions and other authorized moneychangers to strengthen their risk management framework and to remain vigilant and maintain awareness of demonetized currencies and on individuals who many want to exchange such demonetized foreign currencies. On counterfeit notes, the CBSI conducted a number of public awareness on security features of Solomon Islands banknotes and encouraged the public to report any person(s) suspected of producing counterfeit notes to Solomon Islands Police. Finally, on cyber risks, the CBSI issued a new prudential standard on IT Security Risk Management to help insulate financial institutions from IT risks.

CBSI views the FSR as a dais for enhancing and strengthening its overall supervision of financial sector activities, as well as promoting measures to mitigate the emerging risks that could destabilize the financial system; and buttressing collaboration among relevant stakeholders on financial stability. The CBSI performs its financial stability function by identifying, monitoring, and taking actions to eradicate or minimize systemic risks. Such actions are crucial to protecting and enhancing the resilience of the Solomon Islands financial sector, infrastructure, and system.

Overall, CBSI recognizes that financial stability can only be achieved through coordinated efforts of financial sector regulators, self-regulatory institutions, and financial market participants. Effective public awareness of financial system vulnerabilities and resilience in itself may incite financial institutions to restrain activities that may aggravate systemic risks and abet to promote policy reforms to strengthen the resilience of the financial system.

It is my fervent hope that this second edition of FSR will provide useful insights and information to relevant stakeholders.

Unless otherwise stated, this edition of FSR uses data as at December 31, 2017.

Denton Rarawa
Governor & Chairman of the Financial Stability Committee

Chapter 1: SUMMARY

The global financial system strengthened further in 2017. Strong policy support, regulatory enhancements, and cyclical upturn in growth contributed to this outcome. As a result, weak banks have regained strength, systemic institutions have readjusted their business models, market sentiments have improved, and near-term risks to financial stability have tapered off. However, in spite of these positive developments, the global financial system remained vulnerable to the vagaries of unresolved legacy issues, the emergence of cyber risks, the shift in financial stability risks from banking to shadow banking sector and, for emerging and small developing economies, the marginalization from global financial system due to de-risking issues. In terms of regional developments, the financial system of regions important to Solomon Islands, in particular, North America, Europe, and Asia (including Australia and New Zealand) remained fundamentally strong.

In 2017, the Solomon Islands financial system and infrastructure remained strong but continued to show a number of vulnerabilities that may contribute to the materialization of risks to financial stability, as well as to the amplification of their impact. This issue of the Financial Stability Report highlight the pace of credit expansion to the personal sector and high leveraged industries; the uneven distribution of credit across economic sectors; the slow pace of economic growth and capacity of Solomon Islands economy to create new clientele base of banking sector; the exposure of private sector borrowers to Government Sector; the lack of political will to drive the review of financial sector laws and regulations forward; the rapid pace of technological innovation and weak IT Security framework; and the de-risking issues, which marginalized one bank from the global financial system, are critical areas for macroprudential attention in 2018 and beyond.

The nature of risks to financial stability has remained virtually unchanged from the preceding FSR issue. In retrospect, the Solomon Islands financial system remained expose to: (i) credit risks emanating from the pace of credit expansion to personal sector and from the high exposure of private sector borrowers to Government Sector; (ii) governance risks arising from aging legal framework; (iii) operational risks embryonic from fast emerging technology, increase in outsourcing activities, and weak internal controls; (iv) investment risks arising from volatility in interest and exchange rates; (v) liquidity risks stemming from loss of noninterest income due to loss of correspondent bank relationship, high demand for loans and death claim payout from superannuation fund; and (vi) concentration risks arising from limited domestic growth opportunities.

The banking sector continues to maintain its profitability trend over the year. Despite limited capacity of financial institutions to create new markets and increase customer penetration, they remain sustainable to continue provide banking services to their customers and to the Solomon Islands economy. Non-lending revenue continues to back up interest revenue recorded at 45 percent and 55 percent, respectively, during the year. This further supports capital levels to cushion against unexpected losses and to protect depositors' funds. Capital remains adequate and remains well above the 15 percent regulatory requirements at 35.3 percent. Credit remains the major risk and, if not managed prudently, can lead to a systemic risk.

In the case of superannuation sector, the financial performance of the lone licensed provident fund is positive registering a net surplus of $45.6mn during the review period. Despite the overlap of the investment asset allocation, the Fund Board and Management embarked on a five-year rebalancing process to meet the Fund's strategic asset allocation. The current liquidity position of the Fund is adequate. Nonetheless, rising trend of lenders claim and other unspecified withdrawal grounds are imminent threats to the Fund's liquidity. In addition to this, lack of political will to bring to appropriate conclusion the revised NPF Act is a threat to the prudent administration and operations of the Fund.

The insurance sector maintains strong performance in 2017. Despite the shrinkage in insurance market, which is reflected by a drop in gross premium due to non renewal of policies by insureds and closure of some businesses across 2017, the sector remained profitable. This is partly due to less catastrophic events experienced during the year. The decline in the business causes vulnerability in the sector giving rise to risks that may be disastrous if not properly managed. Growth in the insurance sector is achievable; however, low insurance penetration along with and the current stage of economic development the country has reached emerged as a blockage to the growth of the industry.

The credit union sector constitutes less than 1 percent of the overall financial system. Despite the smallness in size, the sector plays a significant role in facilitating and providing an alternative channel to accessing finance. The sector continues to face numerous challenges ranging from governance issues to operational risks. This is eminent due to lack of political will to reform the legal framework to reflect the current market environment and lack of technological innovation and resources to keep pace with the current changes. These challenges have stonewalled the sector from realizing opportunities to provide quality services to its members.

In line with the nature of vulnerabilities and risks identified across 2017, the CBSI introduced a number of macroprudential measures aimed at mitigating vulnerabilities and risks to the financial system. These includes vigorous enforcement of current prudential standards and development of new suits of prudential standards. In addition to this, the CBSI had also directed some licensed financial institutions to strengthen their risk management framework to insulate themselves against the vagaries of governance, liquidity, investment, operational, and liquidity risks. Finally, on the de-risking and correspondent banking relationship issues, the CBSI had collaborated with Solomon Islands Government and with bilateral partners to find a solution for this issue.

Chapter 2: INTERNATIONAL DEVELOPMENTS

The global financial system strengthened further in 2017. This outcome, according to International Monetary Fund (IMF), was driven by strong policy support, regulatory enhancements, and cyclical upturn in growth. Given this conducive environment, weaker banks have realigned their balance sheets and regained their strength. Systemic institutions too have readjusted their business models and restored profitability. Market confidence too have strengthened while near-term risks to financial stability have tapered off. Despite these developments, some challenges remained. These included having to deal with unresolved legacy issues, threats of cyber risks, shifts in financial stability risks from banking to shadow banking, and marginalization of small banks in small developing economies from global financial system due to correspondent banking relationship issues.

During the year, the Basel Committee on Banking Supervision produced a risk-mitigation guideline on management of step-in risks for banks. Most supervisory authorities around the globe welcomed this initiative. This is because the publication of this guideline will help pave the way for equitable enforcements of supervisory and regulatory standards to formal and informal financial sector service providers and because the guideline, which could be implemented by 2020, will address concerns about risks associated with interconnectedness between banking and shadow banking sectors.

In North America, thirty-four biggest banks operating in United States (US) have all passed the Federal Reserve Bank's annual Comprehensive Capital Analysis and Review (CCAR) and Dodd Frank (DF) stress tests. These banks, which hold three quarter of the banking system assets, were for the first time for all of them to pass the CCAR and DF tests. The annual stress tests of the Federal Reserve Bank involved scenarios that included simulated loan losses over nine quarters, the global economy in deep recession, the unemployment rate rising to 10%, and the corporate and commercial real estate market under significant stress. In line with the positive results of these CCAR and DF tests, the Federal Reserve Bank allowed the thirty-four banks to distribute profits to their shareholders during the year.

In Europe, the UK banking system, despite the looming Brexit date, remains resilient. Stress testing exercise performed by the Bank of England (BoE) showed that the UK banks were three times stronger now than they were 10 years ago. In particular, the UK banks were strong enough to perform their core businesses in scenarios that included Brexit outcomes, the advanced economies in deep recessions, the asset prices of banks plummeting, and huge fines imposed on banks for past misconduct. In addition to this stress testing exercise, the BoE had also increased the countercyclical capital buffer of UK banks from ½ percent to one percent in November and had plans on table to review the adequacy of this countercyclical capital buffer in 2018. In Switzerland, the Swiss Financial Market Supervisory Authority (FINMA) took steps to strengthen the resiliency of Swiss banking system by reviewing the outsourcing standards for Swiss banks. The review saw FINMA adopting a principles-based and technology-neutral approach to outsourcing requirements. This approach, according to FINMA, would give Swiss banks breathing space to incorporate FINMA principles into their business models. In Sweden, Swedish authorities had deviated from the tradition of their regional peers by directing four largest banks in Sweden to assign risk weights of above zero to sovereign bond holdings. EU typically assigns a zero risk weight to sovereign bonds. However, the Swiss authorities had decided to deviate from this tradition to minimize risks associated with sovereign bonds in the face of previous threats of default by some EU member countries.

In Asia, China's financial system remained strong, but its exposure to high levels of corporate and household debts; shifts in risky lending from banking to shadow banking sector; and use of implicit guarantees remained at elevated levels. The Chinese authorities, according to IMF, has the tradition of intervening in the market to prevent weaker firms from insolvency and of endorsing debts issued by state-owned enterprises to minimize instability in stock and bond markets. These practices, although will assist weaker firms to clean up their balance sheets and prevent them from closing, will, according to IMF, increase exposure of China's banking system to moral hazards and excessive risk taking appetite practices. Moving northwest, the South Korean financial system remained stable. The system, according to Bank of Korea (BoK), has space to absorb domestic and external shocks. Risks to Korean financial system, according to BoK, lies on the pace of credit growth, the levels of household debts, and the speed of lending to real estate leasing industry. Moving East, the actions taken by the Indian authorities during the year to recapitalize the state banks were welcomed by stakeholders and the rating agencies. Capital of the Indian state banks came under pressure and the banks were likely to breach their minimum capital adequacy requirements following a general slowdown in the Indian economy. This slowdown had led to loan repayments slippages, which prompted a rise in volume of nonperforming loans, and disrupted a supply of credit to the economy. Overall, the Indian banking system remained fundamentally strong.

In the Oceania region, the Australian financial system remained fundamentally sound but challenges surrounding bank profitability remained a concern. Bank profitability of the Australian banking sector slowed due to rising cost pressures and limited domestic growth opportunities. In line with this slowing profitability, the Australian banks streamlined their business models and switched to divestment mode during the year. Across the Tasman Sea, the New Zealand banking system remained strong as macroprudential policies implemented by Reserve Bank of New Zealand (RBNZ) to minimize risks to banking sector in preceding years bore results. The policies included raising of Loan to Value Ratio (LVR) loan, lending standards, and mortgage interest rates, among others. Looking ahead, the NZ banking system, according to RBNZ, remains fundamentally strong but may be vulnerable to risks associated with international asset price volatility, rise in debt levels of other countries, and dominance of four banks with similar exposures and business models.

For smaller economies within the Oceania region, in particular, Pacific Island Countries (PIC), risks of marginalization from the global financial system heightened vulnerabilities of some PICs. De-risking issues became a critical macroeconomic and financial stability matter due to their potential destabilizing effects on the economy of some PICs. The impact of de-risking to some PICs was immediate. These included termination of correspondent banking relationship (CBR), closure of bank accounts of small Money Transfer Operators (MTOs), increase in compliance costs of maintaining existing CBRs, creation of uncertainties about the production and export of some key export commodities, difficulties in establishing new CBRs, and rise in social safety net issues.

De-risking is a global phenomenon. There are many reasons for de-risking but the two most cited reasons for de-risking in the PIC region are: (i) large foreign banks are fearful of being exposed to money laundering and terrorism financing (ML/TF) issues, which such exposure could force their home or US regulators to impose huge fines and regulatory sanctions, which can be damaging to their international standing and reputation; and (ii) emerging countries are perceived as high-risk exposure countries. This perception was partly contributed to by the risk weighting computation methodology the Basel Committee on Banking Supervision issued for emerging countries. Risk weights have implications for risk rating of emerging countries. In that connection, authorities of emerging countries have been calling on the Basel Committee to review the methodology citing low prevalence of ML/TF activities as the reason. However, until such reviews are done, the general perception about the level of risk in emerging countries will continue to off put foreign banks from either extending their presence or from developing correspondent banking relationship with banks in emerging and small developing countries.

In addition to the de-risking issue, the PIC financial system also witnessed emergence of a number of risks. Those risks, if not given sufficient attention now, have the potential to heighten risks of vulnerability and undermine financial stability going forward. These risks include:

- ***Rapid pace of credit expansion to personal sector***. The pace of credit expansion to personal sector in some PICs has been increasing. The expansion, although may contribute to smoothening consumption and maintaining the standard of living, the growth came under the prudential watchlist in some PICs. The reason being that the pace of credit expansion, if permitted to drift away from sustainable path, may elevate levels of household debts and, over time, may have implications for loan repayments, asset quality, profitability, and capital of banks. The growth of credit to personal sector reflects strategies of banks, particularly small banks, to expand lending and increase market shares.

- ***Exposure of banks to nonresident borrowers.*** Some banks have been increasing their exposures to out-of-territory investors and borrowers. Banks in the region engaged in this strategy to increase profitability due to limited domestic growth opportunities. In hindsight, this outward looking growth strategy may have some merits to it but, on the flipside, may have some drawbacks to it as well. One drawback relates to jurisdictional risks. Lending banks may encounter enforcement issues if nonresident borrowers do not honor their loan contracts and therefore have implications on asset quality, profitability, and capital of lending banks.

- ***ATM skimming.*** Infiltration of foreign ATM skimmers in some PICs have exposed vulnerabilities of PIC banking infrastructures to ATM-related crimes. The exposure underscores the need for banks to tighten security features of their banking products and infrastructures and to educate customers on how to protect themselves against ATM skimming. This is important to minimize risks of compromising customer information and of eroding public confidence in the use of branchless banking and digital banking services initiatives.

- ***Liquidity disparity between small and large banks***. Interbank market is not active. This is affecting the distribution of liquidity across banks in most PICs. Large banks have excess liquidity but, for strategic reasons, rarely lend to tight-liquid small banks in the interbank market. This liquidity disparity is hampering efforts of small banks to support business and investment activities of small and micro-entrepreneurs as well as efforts of PIC authorities to develop and grow interbank market.

- ***Circulation of demonetized and counterfeit notes***. Entry of demonetized currencies and counterfeit notes into the system elevates risk of negative perception by developed countries to the level of corruption, black money, and money laundering and terrorism financing activities in PICs. Similarly, it highlights gaps in control mechanisms that PIC authorities have in place to prevent entry of counterfeited notes into the system, which is a risk to national economies, financial institutions, and financial consumers.

But, on the positive side, banking sector in the PIC region remains strong. Financial institutions are profitable, are building-up their capital buffers, which are crucial for insulation against unexpected shocks, and have sufficient liquidity to meet transactional and precautionary demands of their customers.

Chapter 3: VULNERABILITIES, RISKS & MACROPRUDENTIAL POLICY RESPONSES

Vulnerabilities and risks to financial stability remains unchanged from the previous report. In 2017, Solomon Islands financial system and infrastructure remained strong but the system is vulnerable to a number of risks. There is a need to address those vulnerabilities now before it is too late.

1. Vulnerabilities

Pace of credit expansion to personal sector and to seasonal and highly leveraged industries.

The pace of credit expansion to construction, distribution, and personal sectors, and to some seasonal and highly leveraged industries remained a concern. Many of the borrowers in these sectors are major suppliers of goods and services to the national government, provincial governments, and municipal authorities. The suppliers, some of which are small and medium-sized enterprises, obtained working capital from financial institutions (FIs) and have factored into their loan repayment cashflows, settlements from governments and municipal authorities. However, governments and municipal authorities' settlements are somewhat unpredictable. They depend to a large extent on government cashflow situation. This unpredictability created cashflow planning uncertainties across 2017 and adds to vulnerability in the system.

The credit expansion averaged 13.3 percent in the last five years. Although the pace of credit expansion has slowed down somewhat in 2017, the pace of expansion in preceding years could add to debt burden and creation of debt bubble, which may have implications for asset quality, profitability, and capital of financial institutions, in the future.

Asset quality of seasonal industries, in particular, agriculture and tourism, and of highly leveraged industries, in particular, inter-island sea transportation sector, have shown signs of stress. Their nonperforming assets have increased 82 percent and this further adds to vulnerability in the system. In 2017, these sectors came under prudential watchlist.

The asset quality of financial institutions (FI) remained a key concern for financial system stability. The smaller FIs, in a bid to increase their market share, have increased lending in preceding years. However, many of the loan proposals received had been approved at the expense of quality loan assessments and collateral appraisals. As a result, loan quality of these five sectors are doubtful and are likely to deteriorate in 2018. Such deterioration, if not arrested quickly, has the potential to undermine profitability, liquidity, and capital adequacy requirements of financial institutions. To ensure the system has quality assets, and given the need to minimize financial losses in the future, financial institutions were directed to lift their loan appraisal standards, do an objective assessment of the marketability of collaterals provided in the loan proposals, and enhance recovery efforts.

Uneven distribution of credit across economic sectors

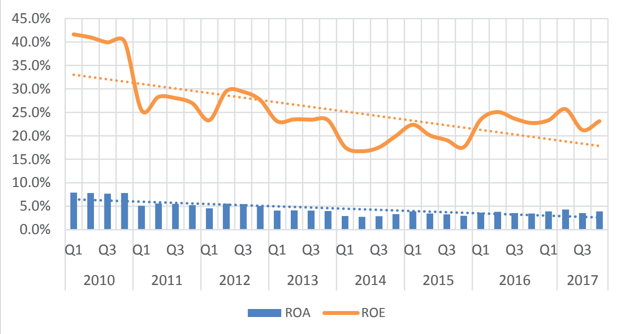
Growth of credit is skewed mainly towards five economic sectors. These are personal, distribution, construction, tourism, and transportation sectors. The skewness in the distribution of credit makes the financial system vulnerable to vagaries of concentration risks. Shocks to either all or to two or three of these sectors have potential to erode profitability, undermine ability of financial institutions to build up capital buffer, and adds to financial sector vulnerability.

The uneven distribution of credit was structural in nature. Policymakers have not given adequate attention to the development of all sectors in the post-independence period. Today, apart from the five sectors, most of the other economic sectors remained largely undeveloped. To reduce the risk of vulnerability to the system, the government must broaden the country's economic base by developing all other economic sectors. Such development will help in spreading risks across the economy and in reducing vulnerability in the system.

Slow pace of economic growth and capacity of Solomon Islands economy to create new corporate clientele base of banking sector.

Sluggish real GDP growth and limited domestic growth opportunities have undermined the ability of FIs to create new corporate customer base. This has resulted in FIs, particularly banks, recycling same corporate and household customers. This has also resulted in some FIs shifting gears to divestment mode by scaling back their provincial presence and operations.

Chart 3.1 Annualized ROA and ROE



Weak capacity of FIs to create new market and increase customer penetration is a concern. For the banking sector, this has led to a decline in long term profitability trend of banks. For insurance sector, this has led to shrinkage in market shares. These outcomes have added to competitive pressures, prompting FIs to either employ risky expansion strategies or to scale back operations to maintain profitability. Sluggish growth heightens risk of insolvency, and adds to financial sector vulnerability over the medium-term. Empirically, the strength of the economy has a positive relationship with profitability and asset quality of FIs. When the economy is strong, profitability and asset quality of FIs improve correspondingly. In that connection, it is essential for Solomon Islands to pool resources together and come up with strategies that will promote inclusive growth and fortify domestic financial system in the future.

Exposure to Government Sector and delay in settling creditors.

Domestic financial system is vulnerable to developments in government sector. When the government sector is strong, risks of vulnerability of domestic financial system to government sector declines and vice versa. The government sector, which comprises the national government, provincial government, and municipal authorities, is the largest employer and consumer of goods and services in Solomon Islands. However, as mentioned above, the practice of government not settling its supplier of goods and services on time is a chronic issue and therefore is a risk to the financial system. The practice has led to slippages in loan repayments of corporate and household borrowers who provide goods and services to government and depends on government settlements to repay loans.

The practice has also disadvantaged borrowers and financial institutions in two other ways. Firstly, it unnecessarily elevated debt-burdens of borrowers, as financial institutions charged high penalty interest rates on late or unpaid loans. Secondly, it unnecessarily tarnished credit ratings of borrowers. Financial institutions send credit history of borrowers to the Credit Bureau of Solomon Islands. This makes access to cheaper credit difficult for those borrowers.

Lack of action and political will to progress review of financial sector laws and regulations.

Financial sector legislations are prudential tools that financial sector supervisors use to assess the risk culture and the corporate citizenship of FIs. However, key financial sector legislations are out-of-date. They lacked vigor and precision that financial sector supervisors need to perform their regulatory and supervisory functions effectively. Solomon Islands financial sector has developed and integrated with rest of the world over the years. Accounting, risk management, FI products and services, and delivery channels have all developed and revolutionized how FIs do business in Solomon Islands over the years. Financial sector legislations need immediate review. However, inaction by relevant authorities to progress review of the financial sector legislations remained a concern. Such inaction adds to financial sector vulnerability. Two policy papers recommending review of National Provident Fund Act and Credit Union Act were submitted to relevant authorities to action in earlier years. However, no attempt had been made by respective authorities to progress the review.

CBSI depends on supervision tools, such as legislations and prudential standards (PG), to perform its mandated responsibilities effectively. The legislators usually approve the financial sector legislations, while CBSI Board approves PGs. PGs set minimum standards on how things are done. Significant progress has been made on this front. However, without upgraded legislations, PGs are just blunt supervisory tools. They lack enforcement authority. They need to be complemented with up-to-date legislations. Financial sector supervisors need legislations that give them the authority that they need to perform their supervisory functions effectively. Inaction is a risk. It elevates exposure of domestic financial system to risk of ineffective supervision.

Rapid pace of technological innovation and weak internal IT Security framework.

The Solomon Islands financial system is entering a new era of technological innovation. FIs are now providing online banking platforms to their customers, a product not available to Solomon Islands banking public seven years ago. They are also providing new generation of payments and financial intermediation technologies such as mobile banking, digital payments and business processes, and cloud computing and data storage. But these advancements have made Solomon Islands financial system vulnerable to cyber-attack and to customer information and data security issues.

From the financial stability standpoint, the rapid pace of technological innovation will have implications on FIs in two ways. Firstly, it will expose FIs information assets and resources to unwanted third parties if the IT security system is weak, and would escalate the risk of loss of valuable financial and technical assets of FIs. Secondly, development of policies and regulations governing IT risks and securities are lagging behind technological innovation and development. This is a global trend and Solomon Islands financial system is not immune to such a lag.

De-risking issues make banking sector vulnerable to corresponding banking relationship (CBR) issues.

Some FIs are vulnerable to correspondent banking relationship (CBR) issues. Any suspension or termination of CBR will marginalize FIs operating in Solomon Islands from global financial system. The closure of international payments channel has potential to disrupt exports of forestry sector, in particular, of round logs. The disruption of round log exports, once materializes, will have a medium to high impact on business operations of some FIs in Solomon Islands and on government revenue collections. The latter will have implications on balance sheets of suppliers of goods and services to government sector, which will have implications on their loan repayments ability and in turn on the asset quality, profitability, liquidity, and capital of banks. Some FIs, although will have some leverage to fulfil their short-term liability obligations, will find it challenging to fulfil some of their time deposit liability obligations.

Forestry sector is the biggest foreign exchange earner of the country, generating 67 percent of foreign exchange earnings and contributing about 18 percent to government revenues. The issue of de-risking and its impact on corresponding banking relationship will, therefore, have a medium to high impact on: (i) Solomon Islands economy; (ii) the government's ability to honor its debt obligations with its domestic creditors; (iii) the ability of private sector to undertake financial planning with certainty; (iv) will erode the volume of quality assets in the system: and (v) will undermine ability of FIs to build-up capital buffer. It is therefore important for all stakeholders to address all critical areas that could potentially accelerate de-risking issues in Solomon Islands.

2. Risk to Financial Stability

Credit Risk arising from the deterioration of asset quality, combined with low potential growth in lending activities.

During 2017, the asset quality of banks and credit unions remained a key concern for financial system stability. Many of the FIs, in a bid to increase market share, have increased their lending at the expense of quality appraisal. Quality of loan books among these institutions remains a concern. Non-Performing Loans (NPLs) have increased and loan performance is likely to continue deteriorating over the next period in the face of slowing economic expansion and limited domestic growth opportunities. In line with this outcome, the NPL rate, which is a measure of bad assets in the system, hovered above CBSI's threshold of 5 percent and the volume of watch loans remained historically high.

The mounting level of NPLs occurred due to the combination of ongoing chronic delay by the government to release payments to government's contractors and service providers, who in return rely on government payment to repay loans, weakened the debt servicing capacity of borrowers. Higher levels of indebtedness in consumer household sector, particularly from loans obtained in preceding years from banking and shadow banking sectors, and weak economic growth have also contributed to the rise in NPLs in 2017.

Rising NPLs is a risk. For FIs, a rise in NPLs will: (i) reduce income earnings contained in the original loan contracts; and (ii) impose additional costs to the management of those assets. Reduction in anticipated income and profitability will not only impede efforts of FIs to reverse the declining profitability trend but will also affect the capital adequacy and liquidity positions of FIs. This outcome can force FIs to become more discriminating in their lending decisions and undermine financial inclusion initiatives of Solomon Islands.

Governance risks arising from aging legal framework.

Corporate governance framework is critically important to safeguard financial stability. The Solomon Islands financial system is susceptible to governance risks due to weak governance policies and outdated legal framework.

Financial institutions, especially banks, superannuation, and credit unions deal with people's funds. Any breach of trust will undermine confidence the banking public has on banking system, which has potential to set off run on banks. The recent global financial crisis illustrated FI boards' lack of understanding about the risks faced by their institutions, and an absence of robust governance frameworks through which they could monitor the risk-taking actions of management.

Weak corporate governance in the financial sector increases risk profile of FIs and exposes the sector to risks associated with: (i) fitness and propriety issues; (ii) conflict of interests situation; (iii) weak corporate risk culture; (iv) weak processes and internal systems; (v) inefficiency in allocation of resources; (vi) fraud and nepotism; and (vi) incompliance to laws and policies governing the financial sector, as for instance, lack of timely updating and regulatory reporting on the financial performance of the financial institutions.

Operational risks embryonic from fast emerging technology, increase in outsourcing, and weak internal controls.

Operational risks remain an area of concern given the challenges FIs, particularly banks, have to face with given the rapid penetration of financial technologies. High and growing reliance of banking operations on Information Technology (IT) platforms, digitalized product channels for banking services, outsourcing to third-party providers of IT-related tasks and functions, and communication networks, renders banks vulnerable to operational risks.

FIs embraced the emergent technology, and have come to rely on technology to help support their business processes, particularly in handling massive amounts of critical information and data. Despite the positive implications of embracing technological advancement, the decision to onboard businesses with technology comes with a lot of risk. These include: (i) increase of cyber incidents; (ii) information theft; and (iii) IT business disruption due to adverse events. FIs should treat these threats very seriously and actively invest in raising the reliability of their security and crisis response capabilities.

In addition to technological dependence, the trend of FIs engaging in outsourcing some of their key functions to third party service providers are also on the rise. FIs engaged in outsourcing activities for a variety of reasons but chief among those reasons were information storage and processing considerations. FIs say it is cheaper to use pooled resources at regional hub to perform some of their key functions. However, outsourcing is an observable operational risk. If not handled properly, it can elevate strategic, reputational, and compliance risks of FIs.

Investment risk arising from volatility in interest rate and exchange rates.

The banking sector, insurance sector, and the superannuation sector have investment portfolios offshore. The volatility of foreign interest rates and fluctuation of exchange rates, in the face of underdeveloped interest and currency hedging facility, is a risk to the domestic financial system stability. Under current setting, risks of asset revaluation loss emanating from offshore investments and of real negative returns from domestic investments remained at elevated levels. This possible outcome, coupled with rising cost of doing business, has affected profitability of FIs and discouraged domestic investors from investing in domestic market. The latter has affected capacity of some smaller FIs to attract stable sources of funding, which are important for long-term stability of FIs, and have induced households to participate in Ponzi schemes.

The financial system is exposed to liquidity risks stemming from high influx of loan proposals, superannuation retirement and death claim payout.

Liquidity risk remained a major concern for the financial system. Credit Union Sector, and the Superannuation Fund experienced some liquidity pressures during the year. The credit union sector came under liquidity pressure in the face of high volume of high non-performing loans, many of which were unsecured, constricting the main income source of credit unions. This outcome had led to a mismatch between the demand for loans and membership withdrawals, on one hand, and the supply of funds to match the demand for funds, on the other.

Twelve percent of Fund membership have reached 50 years of age while another twenty percent of membership will be reaching their retiring age within the next five years. Similarly, a large percentage of two-thirds of pledge collateral arrangement held by commercial banks with the Fund on behalf of their customers are listed for call-up soon. Similarly, the Special Death Benefit (SDB) scheme offered by the Fund to family members of the deceased Fund member is on the rise. The SDB scheme, which is a form of insurance, has been increasing the exposure of the Fund to liquidity risks. This is because of the mismatch between the amount of premiums paid by members and the volume of claims paid out, causing depletion of SBD scheme budget within few months of each financial year. Given the mismatch between the supply of and the demand for SDB, excess demand for claims payout are drawn from the Fund's capital reserves. All these factors will dent the liquidity position of the Fund.

De-risking stemming from Corresponding Banking Relationship.

De-risking is a new concept affecting a number of countries around the globe which once not addressed properly will have implications on profitability of FIs, economic growth, and financial stability. De-risking refers to big FIs terminating the correspondent banking relationship with small FIs due to perceived level of riskiness. Big banks are fearful of being exposed to money laundering and terrorism financing activities because such exposures could land them with regulatory fines and reputational damage.

In late 2017, a foreign bank suspended the correspondent banking relationship it has with a small FI. This suspension, which eventually led to a termination, has marginalized the said FI from global financial system. Absence of international payments and clearing channels elevate risks of instability for two reasons. Firstly, it will have implications on profitability and hence on stability of the said FI given that a sizeable proportion of its noninterest income comes from trade-related flows and, secondly, it will have implications on the economy and the government sector. Forestry sector contributed 12.2 percent to Solomon Islands Gross Domestic Product (GDP), 67 percent to foreign exchanged earnings, and 18 percent to government revenues. The shutdown of forestry sector will elevate risk of instability to the financial system.

Concentration risks stemming from limited domestic investment and growth opportunities.

Credit to private sector is concentrated in five economic sectors. Part of this lending concentration reflects lack of prioritization given by successive governments to other sectors of the economy. Lack of diversified sectorial development has exposed FIs and Solomon Islands financial sector to vagaries of large credit and concentration exposure, which has potential to undermine efforts of FIs to diversify risks across the economy, reverse their declining profitability trend, and build up appropriate liquidity and capital buffers for insulation against unexpected shocks in the future.

3. Macro-prudential Policy

In response to financial stability risks detected, CBSI introduced a number of macro prudential measures aimed at mitigating risks to the system. These are:

1. **Vigorous enforcement of current prudential standards, development of new prudential standards, and lifting of loan proposal and collateral assessments**: CBSI had vigorously enforce prudential standards in capital adequacy requirements, large credit exposures, foreign currency open positions, and asset classification and minimum provisioning require-

ments. On top of these, CBSI had also directed some FIs to lift their loan appraisal and collateral assessment standards and developed new prudential standards aimed at minimizing risk to the system. These new prudential standards included business continuity management, outsourcing arrangements and practices, IT risk management, and related party transactions.

2. **In response to corporate governance risk, CBSI directed financial institutions to review and strengthen their corporate governance framework so that they conform to best internationally-accepted practices**. CBSI had directed some FIs to develop risk management policies, fit and proper policies, crediting rate policies, reserving policies and remuneration policies. In addition to this, some FIs were directed to strengthen their weekly, monthly, and quarterly prudential returns reporting. On top of these, CBSI had also directed some FIs to develop succession planning for persons holding responsible persons position such as board of directors and senior managerial positions. All these actions are aimed at reducing corporate governance risks.

3. **In terms of operational risk, CBSI had directed some financial institutions to review their current operational framework so that they conform to best internationally-accepted practices**. In particular, CBSI had directed some FIs to create and instil risk culture institution-wide as a line of defence. To minimize impacts of reputational risks to the system, CBSI requested FIs to strengthen their anti-money laundering and terrorism financing framework, document and disseminate operational policies and procedures for familiarization to staff. In addition, CBSI had also directed FIs to establish their disaster recovery site and to test their effectiveness in line with prudential standard on Business Continuity Requirements. To further strengthen the operational framework, FIs were also directed to ensure their Management Information System [MIS] has appropriate triggers that exposes operational risks.

4. **In response to investment risk, CBSI has directed financial institutions to review their current investment framework to conform to best internationally-accepted practices**. CBSI has directed some FIs officers responsible for investment to undertake refresher investment skills and training to broaden their market intelligence and portfolio construction understanding with offshore vendors. In addition to this, some FIs were directed to formulate their investment, compliance and valuation Policies to strengthen their investment framework.

5. **In terms of liquidity risk, CBSI has directed financial institutions in two sectors to strengthen their liquidity management framework**. In particular, credit unions and Solomon Islands National Fund (SINPF) were directed to strengthen their liquidity planning and management framework. For credit unions, this includes establishing credible cash-flow models, lifting loan appraisal standards, implementing appropriate asset recovery strategies, and developing and applying appropriate loan repayment schedules aimed at narrowing the lending-repayments horizon mismatch. For the provident fund, CBSI requested SINPF to engage investment science experts to assist them develop a credible investment framework and actuarial science experts to help them analyze and develop risk mitigation strategies and management.

6. **In response to de-risking issues, CBSI collaborated with bilateral and multilateral organizations and other Pacific Island Central Banks to find a regional solution**. De-risking has affected one small FI and increased compliance cost of another. In terms of short term policy responses, CBSI has directed the former FI to strengthen its governance and operational risk framework and to concentrate on domestic banking activities, on less volatile funding sources, and to buildup liquidity, AML/CFT, and capital buffers in preparation for a correspondent banking relationship enhanced due diligence assessment in the future.

7. **Finally, the largest FI in Solomon Islands was directed to diversify its investment portfolio to reduce concentration risk.** In particular, CBSI requested the Fund to invest in domestic and overseas market. On former market, CBSI cautioned the Fund against investing in same sectors, in highly leveraged industries, and in acquiring equities from corporations with weak financial positions. On latter market, CBSI requested the Fund to invest a fraction of their funds in portfolios offshore by engaging services of a fund manager and by strengthening the surveillance of their offshore portfolio investments.

Chapter 4: DOMESTIC DEVELOPMENTS

1. Banking Sector

The banking sector remained the largest important sector in Solomon Island's financial system. As at end of December 2017, the sector held 61 percent share of the financial system. The sector has expanded with two new entrants into the market. With the new entrants, one was granted with a full banking license to conduct banking business and the other was granted a banking license to operate as a credit institution. The former operates as a branch and the latter as a subsidiary of foreign owned financial institutions.

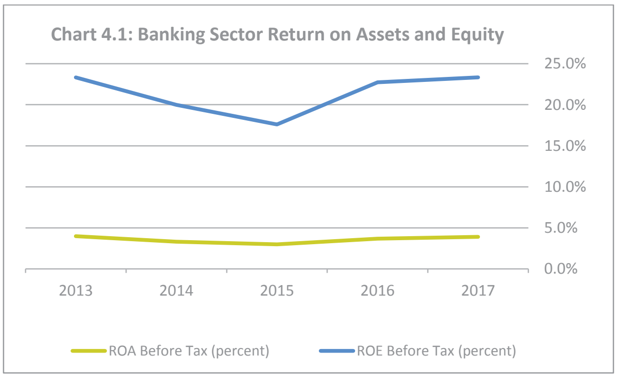
The increase in the number of financial institutions would allow for more opportunities for customers and public to have access and choices to the products and services provided. The new entrants into the market also saw the major existing banks simultaneously reducing their footprints in the provincial centres. For example, one of the most reputable banks in the pacific region has commenced pruning its branches network in the country with a closure of its branch in Auki, Malaita province. The closure was due to low volumes of transactions coupled with uneconomic viability of its branch network.

The closure of provincial branches has also led to the banks becoming innovative and moving rapidly to embrace digital banking by continuing to provide banking services to customers through digital banking platforms. It is the trend now, that banks are investing more into digital banking services as their ongoing commitment to the pacific region, Central Government and Central bank's goal of a digital future for the Solomon Islands.

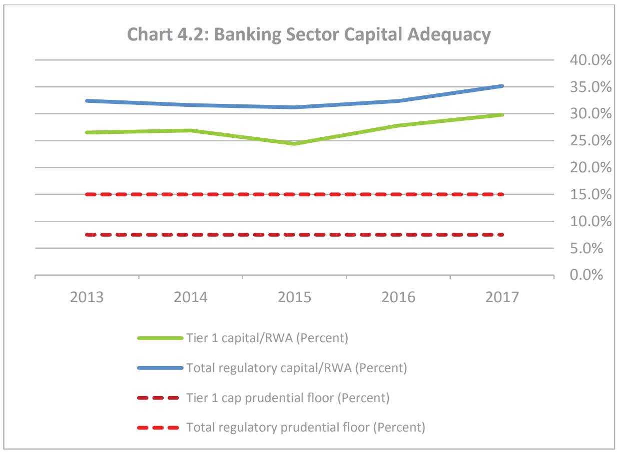
1.1 Banking sector Performance 2017

The banking sector remained profitable in 2017. Interest income on lending activities remained the major source of revenue for the sector, accounting for 55 percent of total gross income. This was supported by non-lending income mainly from gains on foreign currency revaluations, fees based income on foreign exchange operations and deposits services, and other income sources, which catered for the remaining 45 percent of the pie. This income structure remained the same over the last five years. The cost efficiency ratios were also contained below the 50 percent threshold at 47.2 percent. Overall, the main profitability indicators on average were recorded at 3.6 percent and 20 percent, respectively, for Return on Assets (ROA) and Return on Equity (ROE). This indicates strong and sustainable profitability positions of banks (See Chart 4.1).

In line with strong profitability indicators, capital levels also remained strong well above the 15 percent regulatory prudential limits. Total regulatory capital to risk weighted assets was registered at 35.1 percent in December 2017, and has maintained the level for the last five years. Banks are adequately capitalised and capital serves as a safety net for a variety of risks to which the banks are exposed to in the course of their business.



Asset quality of the banking sector is measured in terms of its nonperforming loans (NPLs) compared to credit growth. Credit growth of the lending sector was stable year-on-year basis, which had significantly contributed to the profitability of the sector. This led to loans and advances accounting for 41 percent of total assets. The remaining 59 percent of assets were placed in debt securities issued by CBSI and balances due from CBSI, which deemed to be low risk assets. In 2017, asset quality of the banking sector was satisfactory, however this had declined towards the end of the year to settle at 6.1 percent in December 2017, slightly higher than the CBSI's 5 percent prudential threshold. Credit extended to personal sector remained the major contributor to the NPLs and accounted for 49 percent in 2017. Specific provisions to total NPLs on average were around 24 percent. This indicates that the sector has capacity to effectively accommodate any credit risk and has less impact on the overall quality of the assets. In addition, the remaining portion however should be cushioned by capital.

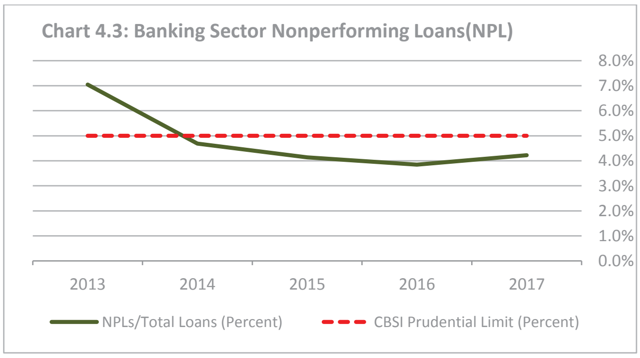


The banking sector was highly liquid with deposits to loans ratio of 146.7 percent and liquid assets to short term liabilities ratio of 55.5 percent. Liquid assets to total assets ratio was 38.6 percent. These high ratios indicate that the banking sector has sufficient funds on hand to meet its obligations as they fall due, and be able to grow its asset base.

The ratio analysis, which determined the sensitivity to market risk, was currently rated low at 3.8 percent as indicated by the net open position in foreign exchange to capital as at end of 2017. This indicator has shown that the banks' exposure to foreign exchange market was within the regulatory limits of 25 percent and 15 percent for both overall and single open position limits (See Chart 4.2).

1.2 Banking sector major risks

Credit risk remained high for the banking sector as NPLs soared by 68.1 percent over the course of 12-month period to $141.4 million. The increase in NPLs over the period was mainly driven by the manufacturing, construction, distribution, and personal sectors. The ongoing systematic delay by the government to release disbursements of funds to contractors and suppliers of goods and services to government sector had caused inefficiency in timely repayments and mismatch to terms of loan and advances facilities been drawn from the banks, leading to loans arrears. Majority of these borrowers relied on government payments to service their loans as required; they are residential property owners and commercial businesses in the construction sector. Such delay in payments by the Government can have a domino effect on the financial sector, which in turn becomes detrimental to the entire economy (See Chart 4.3).



Another contributing factor to the increase in NPLs, especially to the personal sector, is borrowers resorting to willful defaults. Some of the banks' core banking systems functionalities cannot perform timely automatic deduction of loan repayment amount from borrowers' salary accounts to service loans. This has allowed borrowers to withdraw their whole salary amount including the loan repayment amount from their bank accounts. It is a concern among banks that core banking systems used may need to upgrade their loans servicing and management functionalities to control loan repayments serviced through salary, and allow automation of crediting borrower's salary accounts for the purpose.

The continued extension of credit to these high non-performing sectors, particularly when it has linkage to the government sector and other major financial institutions like the superannuation fund, is a risk to the stability of the financial sector. Banks are likely to be more vulnerable to losses from this sector, especially if loan performance worsens and provisioning for loan losses are not adequate. This may have contagious effects to the government sector and other parts of the economy. At most, banks should be at the forefront to manage this risk especially by strengthening their credit underwriting standards and aligning their level of risk-taking appetite considering the business environment they are operating in. To further manage credit risk, lending practices should be adequately supported by written policies and procedures and should be implemented and adhered to minimise any losses.

In line with credit risk, de-risking is a global issue in which major financial institutions are reducing their presence and exiting certain market environments including ceasing off any business relationships or arrangements due to the financial threats and vulnerabilities that may impact their financial health and reputations. In light of this, the lending sector had experienced strategic changes, and resolves to downsize certain operations with the presumption that it is a high risk for small locally incorporated banks. Thus, not only in Solomon Islands but an experience in the PIC region as a whole.

The rise in shadow banking is an emerging risk, although its degree of interconnectedness with banking sector is negligible. Shadow banks are unregulated and, given their fast loan services, have attracted a lot of formal banking sector customers. This adds risk to the system and increases debt burden of clients who are also clients of the formal banking sector, and could be a loophole for the rise in NPLs of personal sector.

Furthermore, non-lending risks is also on the rise for banks operating in Solomon Islands (SI). For example, the rapid growth and innovations and the internationalization of financial flows are changing the banking landscape in Solomon Islands. In the same vein, the national objectives to support global agendas, in particular, the promotion of financial inclusiveness and the fight against money laundering and terrorism financing activities, are also driving changes in the banking sector. These changes will enhance the reputation of Solomon Islands banking sector, provide banks with access to additional funding sources, and stimulate inclusive growth going forward.

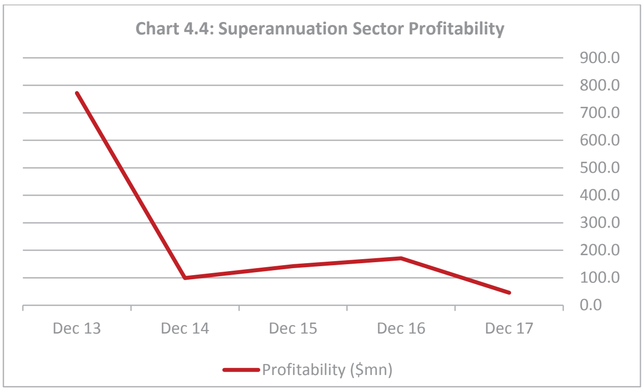
One other major non-lending risk is the foreign exchange risk. Banks in SI now have more exposure to foreign exchange risk. This exposure may imply a high volatility of earnings and profitability and a different risk profile from that of traditional banking. For example, the issue of correspondent banking relationship will adversely affect banks foreign exchange income. In view of that, foreign exchange risk, due to exchange rate movements may not be volatile for SI financial system, but major trading currencies market movement are volatile and at times unpredictable.

Consequently, the complementary objective of promoting financial inclusion and maintaining the reputation of the financial system is a concern. This complementary objective will change the landscape of traditional banking business model in Solomon Islands in terms of product delivery channels, operations, technologies, business strategies, and business culture. But such a change will also increase inherent risks, in particular, strategic, operational, Information Technology (IT), and earnings risk for banks.

2. The Superannuation Sector

2.1 The Fund performance

Solomon Islands National Provident Fund (The Fund) recorded a net profit of $45.6 million for the year ended 31st December, 2017. In the first half of 2017, the Fund registered a net profit of $43.1 million. The Fund's main sources of income were dividends, interest earned, rental income, and gains realised from investments. High profitability in the first half of 2017 reflected inflows of dividend income, which are usually received during the first half of the year, while the decline in profit in the second half of 2017 reflected the decline in earnings from unrealized gains and dividend income (See Chart 4.4).

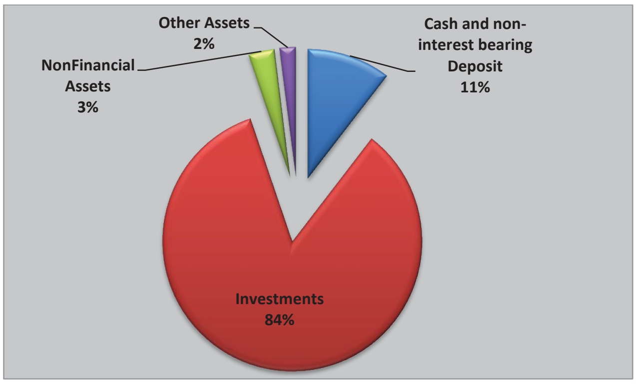


The Fund earnings are volatile given that most of its investments were placed in high-risk investments. This means the Fund must have a proper monitoring mechanism in place for both domestic and offshore investments to guide Fund Management achieve the target return of the Fund. Proper monitoring of offshore market is also vital despite offshore portfolios constituting only 11 percent of the total investment portfolio. The Fund must ensure its human resources are equipped with adequate financial and investment science knowledge and skills. This is because any adverse movements in the international market and any inadequate provisioning of non-performing investments would impact negatively on the overall performances of the Fund and on the general reserves of the Fund.

2.2 Investment and Market Risk

The Fund's balance sheet composition was dominated by investment assets, which accounted for 84 percent of the total assets (Chart 4.5). The composition was consistent with the main vision statement of the Fund, which is to provide comfortable life during and after retirement.

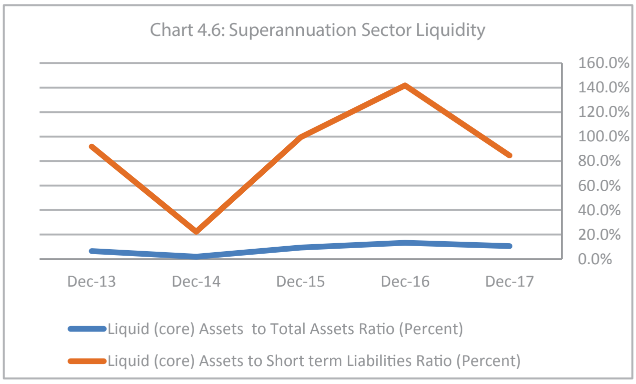
Chart 4.5: Superannuation Total Asset Composition for 2017



To achieve the main objective of the Fund and earn adequate earnings for members, a proper asset allocation of the Fund investment is vital. The Fund has an asset allocation matrix but adherence to it remains a challenge. A good number of allocations have overshot the upper bound of the allocation matrix. It is important for the Fund to ensure that adequate monitoring and reporting of the investment portfolio are put in place so that the balance between risks and returns are managed at the acceptable level. Total assets remained unchanged compared to first half of 2017. Equity remained the highest exposure of the Fund and constituted 50 percent of the Fund's total investments. The other 50 percent were invested in time deposits, investment properties, Government securities, and term loans. The Fund, as in preceding years, was also exposed to concentration risk due to the small size of the economy and limited domestic growth opportunities.

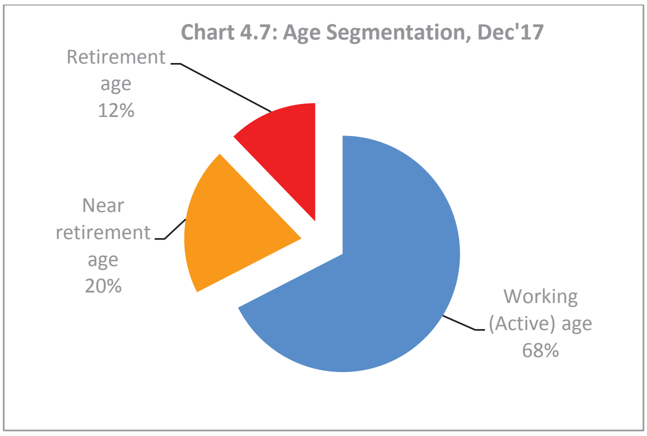
2.3 Liquidity and Demographic Structure

The members' contributions (savings) comprised 96 percent of the total liabilities. The remaining 4 percent represented 'other' liabilities. The Fund has ample liquidity to



support its operation across 2017 and to meet its financial commitments in 2018 (See Chart 4.6).

Despite the low liquidity risk, the Fund management must remain vigilant for any unexpected demand for withdrawal. The current membership profile of the Fund indicated that 12 percent of the Fund's membership have reached 50 years of age while another 20 percent of the membership neared the retirement age (see Chart 4.7). Moreover, unspecified withdrawals and lenders' claim on



the two-thirds collateral are also rising. These means that the Fund would expect to receive a high demand for withdrawals soon.

In this context, it is essential for the Fund to consider engaging an actuarial science expert to deal with measurement and management of risks and uncertainty of the Fund. Furthermore, the Fund should also consider performing regular scenario analyses to assess the resilience of the Fund to various shocks taking into account the demographic structure of the Fund to ascertain the level of capital reserves and amount of available liquid funds required in the event of financial distress.

2.4 Operational Risk

Adequate information management system is critical to compliment the smooth flow of process and efficient use of resources to achieve the objective of the Fund. As such, the project that the Fund embarked on to integrate IT system and processes, which is near completion, is a step in the right direction. That said, it is critical for the Fund to conduct proper testing and quality assurance on the reliability of the systems before implementation and adoption to minimize disruptions during the transition.

2.5 Legal Framework

The overarching challenge for the Fund is the current legal framework. The National Provident Fund Act is out of date. It needs to be reviewed to onboard best practices and gives clarity to financial sector supervision. A draft bill was prepared a couple of years back but successive governments stonewalled its progress due to disagreements over the pledging recommendation. The delay to progress the NPF Bill increased the risks on governance and operations of the Fund, and over time will undermine its profitability and capital reserves.

One of the stability issues identified in the current NPF Act relates to Special Death Benefit (SDB). SDB is an indirect form of insurance where the Fund gives money to the family of deceased member. The mismatch between the amount of premiums paid and the volume of claims paid out raises the vulnerability of the Fund to SDB scheme. Due to the mismatch, the SDB scheme usually tapped funds from the capital reserves account of the Fund to finance the shortfall. This practice increases the risk of instability, and since 2014 has been the main driving force behind the declining trend of the Fund's capital reserves.

The second stability issue identified in the current NPF Act relates to the crediting rate of the Fund. The Fund, under the current NPF Act, is required to pay interest of not less than 2.5 percent to members each year regardless of the Fund's financial performance. This proviso is good for the Fund's members but is not good for the Fund as an institution. With the volatility in the business environment, this means that the Fund may perform well in some years but not so well in some other years. The Fund's future financial performances depend on the business cycle of domestic and international economies. This means that future crediting must be aligned with financial performances of the Fund. For this to happen, legislatures must have the will to make the necessary change and progress the review of the current NPF Act.

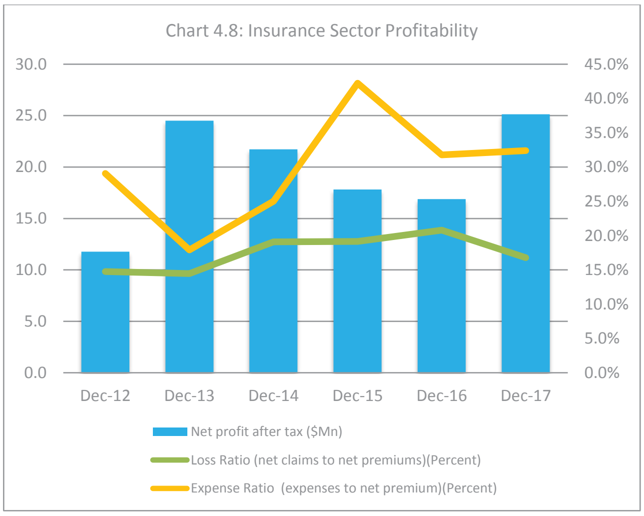
Meanwhile, lack of appropriate provisioning policies for substandard investment and receivables have heightened risk of vulnerability of the Fund. Lack of such policies imply that financial losses associated with ill investments are written off against general reserves. Such practice over time has the potential to substantially deplete the general reserves account. There is therefore a need for the Fund to have a proper reserving policy in place.

3. Insurance Sector

Despite its size, the insurance sector plays an important role in providing security against financial losses. There are potentials for the sector to grow. However, the low insurance penetration persistently hinders growth in the insurance sector. The low uptake in the insurance industry coupled with the closure of several businesses and the low economic development in the country also affects the premium income. Fluctuations in interest rate have also caused uncertainty in the insurers' investment decision.

In spite of the setbacks in the local insurance market, the insurance sector remained profitable. Profit after Tax increased by 23 percentage points to $14.7 Million over the year. This was driven by a fall in net claims and expense.

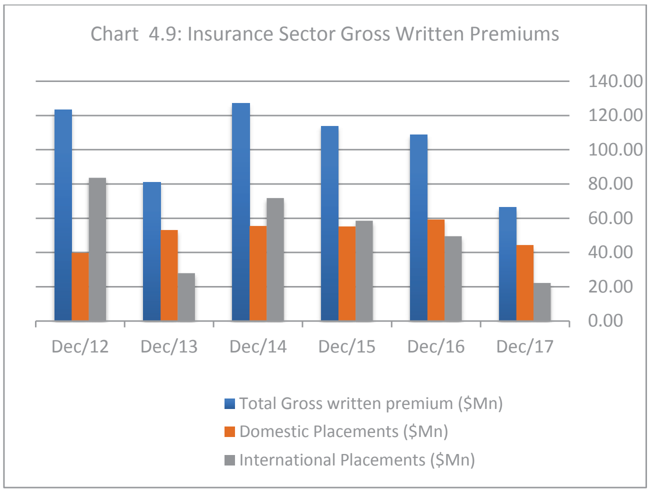
The loss ratio, which depicted net claims to net premium, remained stable across 2017 due to less catastrophic events during the year. The loss ratio for the sector stood



at 16.8%. This outcome showed the strength of solvency by the insurance sector to absorb claims when due (Chart 4.8)

Despite the profitability, the insurance sector has registered continuous decline in its gross written premium (main source of revenue for both the local and overseas insurers), a trend witnessed since 2014. The decline was set off by non-renewal of policies by insureds due to unstable cashflow and closure of few businesses experienced during the course of 2017. Retirement of Gold Ridge Mining Company and Regional Assistance Mission to Solomon Islands (RAMSI) in 2017 also took with them other supporting businesses causing a shrunk in the market size. These have led to a decline in international placements, which included premium paid through local Insurance brokers and Insurance companies, for insurance policies provided by offshore insurers. Total Gross Written premium slumped by 38.8 percent from $108.78 Million in 2016 to $66.56 Million in 2017.

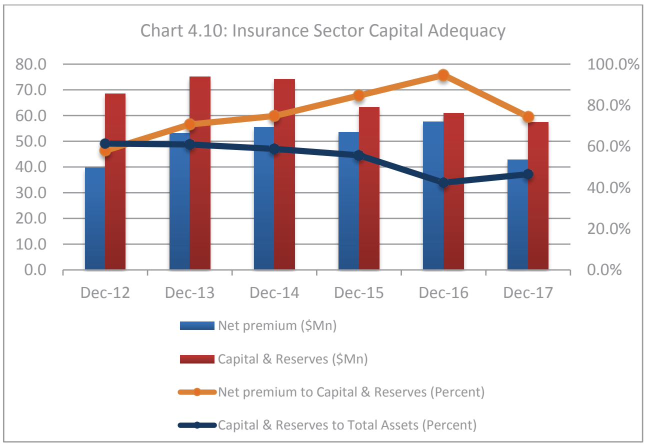
More so, domestic placements also decline, by 25 percent from $59.9 Million in 2016. Premium paid to domestic licenced insurance companies for insurance covers declined



as the market size deteriorates. Nevertheless, premium paid for Insurance classes of fire, motor vehicle, employers' indemnity and house owners' continued to fuel the premium pool (Chart 4.9).

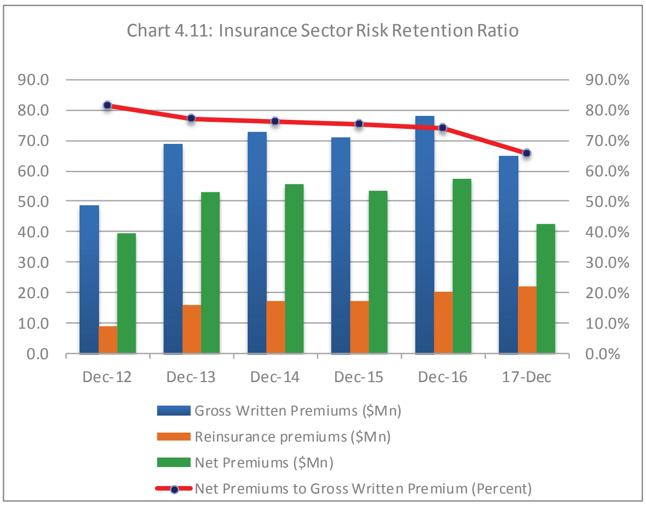
The sector's capital adequacy ratio (total capital & reserves to total asset) amounted to 46.5% in 2017, up from 42.4 percent in 2016. The increase reflects a decline in total asset from $142.5 Million in 2016 to $123.5 Million in 2017. The decline was caused by a decrease in insurance technical reserves and a decline in premium receivables due to non-renewal of policies during the year.

Premium to net capital reserve also declined, from 94.7 percent in 2016 to 74.4 percent in 2017 (Chart 4.10). The



outcome resulted from a drop in the number of insurance policy issued by domestic licenced insurers as well as a reduction of premium rates and application of heavy discount by some. Total outstanding claim reduced by 40 percent to $7.2 million in 2017.

The insurance sector continues to ensure safety for its policyholders against severely adverse scenarios through reinsurance arrangements. Records show that with total



premium of $65 Million receipt in 2017, 79.4 percent of the total risk was retain while approximately 20.6 percent reinsured with reinsurance companies overseas. This is a clear reflection of the capacity of domestic licenced insurer to take on risks in the local insurance market.

In terms of the sector's liquidity position, short-term liability declined at a faster pace than the drop in liquid assets. As a result, the ratio of liquid asset to short-term liability for the sector rose from 115.5 percent in 2016 to 134.3 percent in 2017 (chart 4.11). This outcome implies that the sector is in a stable position to meet its short-term obligation.

The rise of liquidity ratio reflects a decrease in commission payable to insurance intermediaries, unearned premium and outstanding claims payable to policyholders.

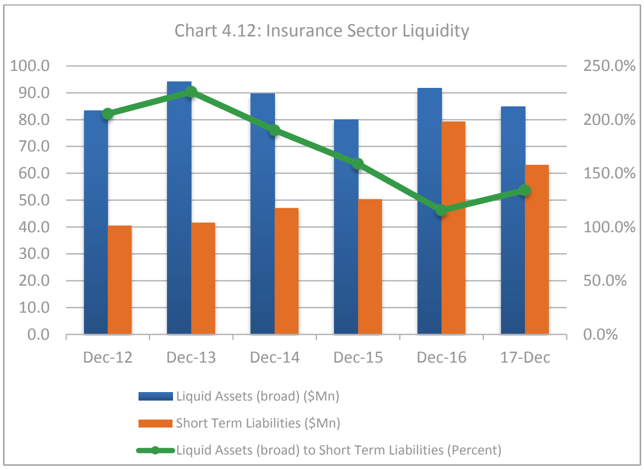


Chart 4.12: Insurance Sector Liquidity

The sector's total asset decreased by 14 percent to $123.5 Million in 2017 compared to an increase of 26.3 percent recorded in 2016 (chart 4.12). The decrease in total asset was

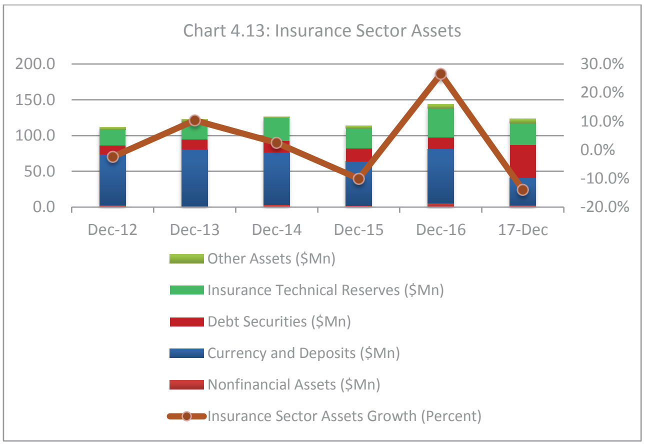


Chart 4.13: Insurance Sector Assets

cause by decline in currency and deposit (demand and saving deposit) held with commercial banks along with Insurance technical reserves resulting from low premium receipts, and a slant in non-financial assets.

Currency and deposit dropped by 49.3 percent to $38.3 Million in 2017. Insurance technical reserve decreased by 25.9 percent while non-financial assets slumped by 57.4 percent (Chart 4.13).

Total liability decreased by 20 percent to $66 Million in 2017, contrasting the 64.6 percent increase recorded in 2016. The sector experienced a decline in its liability due to reduction in unearned premium liabilities resulting from less policy issued during the period, and backdrop in outstanding claims owed to policyholders as due to less claims recorded.

The insurance sector remains solvent. However, the sector is vulnerable to risks associated with the dwindling size of the insurance market. This is due to nonrenewal of policy by insureds, the closure of some business across 2017, and the low demand for insurance products by the majority of Solomon Islanders. This calls for close monitoring and management. A shrinkage in the Insurance market size may give rise to competitive pressures, causing insurers to undertake risky strategies in order to maintain their market shares. Such strategies may include **(i)** reducing premium rates and applying heavy discount to attract new businesses; **(ii)** lowering underwriting standards to accommodate more businesses in order to enhance growth in gross written premium; and **(iii)** increasing risk exposure in some portfolios to maintain competitive edge. While these strategies may sustain the insurer in the short-term, it undermines the insurer's long-term viability; placing both the insurer and policyholders in a vulnerable position against future adverse scenarios. These can develop into a systemic risk if it is not properly managed.

4. Credit Union Sector

Credit unions were established in Solomon Islands with the concept of members helping members. Help in this context means members having access to cheaper finance and training and education on financial management. The

Balance Sheet Statement (million)	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Total Loans	36.1	37.1	40.1	40.5	43.1
Total Assets	50.6	52.6	58.4	61.4	63.2
Total Deposits/Savings	37.1	39.6	48.1	45.7	49.2
Total Share Capital	13.3	13	10.2	10	9.3
Income Statement (million)					
Income ($million)	5.3	5.3	4.8	5.5	4.9
Expenses (million)	2.6	2.3	2.1	3.2	2.2
Net Surplus (Loss) ($million)	2.7	3	2.7	2.3	2.7
Statistic Data					
No. of reporting Cus	10	10	10	10	10

Source: CBSI

common bond determines the membership qualification with objectives to promote savings and judicious usage of money.

In 2017, ten credit unions submitted their quarterly financial reports. Based on their submissions, the total assets of the sector amounted to $63.2million, of which 68 percent were loans granted to members (Table 4.1).

Like any other financial intermediaries, financial risks are also present in credit union activities and if not managed prudently can be detrimental to the safety, soundness, and reputation of the sector.

4.1 Credit Unions Legal framework

The Credit Unions Act Cap 165 was enacted in 1986. It is deemed out of date and lacked precision. The Current Union Act was reviewed and a Bill drafted. However, lack of political will stalled the progress of the Bill. Further delays to progress the passage of the Bill will deny the sector from innovation and opportunities to best serve its members. It will also deny the financial sector supervisors to perform their oversight functions effectively.

4.2 Fit and Proper Challenge

The Ownership structure of credit unions entailed members as "shareholders and customers". This twin structure rendered a huge challenge to the sector with respect to fit and proper issues, which demands high level of knowledge and skills mix to effectively manage members' funds. The structure has allowed the Boards to involve directly in the day-to-day affairs of the credit unions.

This dilemma has resulted in members, particularly Board and committee members, compromising their responsibilities. This means the credit union philosophy of members helping members are usually abused by persons holding responsible positions.

The spirit of Volunteerism in which members devote a fraction of their time and resources to manage the operations of credit unions is a challenge. Some elected board and committee members are reluctant to volunteer their time due to their heavy workload and fear of losing their paid employment.

4.3 Non-Performing Loan and Default Risk

One of the main activities of the sector, apart from accepting deposits from members, is extending credit. The sector recorded a loan growth of 6 percent from $40.5 million in 2016 to $43.1million in year 2017. Despite the growth, the sector remains critical as substantial portion of the loan portfolio were unsecured and non-performing due to unsustainable lending practices. Also there was no monitoring to detect problem loans to take timely corrective action to rectify on an early stage of the loans inceptions. This has further deteriorated the quality of the loan book, which has impacted the earnings and capital.

This imprudent practice resulted from weak loan assessments and non-adherence to own lending policies. As such, extending of credit is sometimes based on relationships and employment ranking status of the membership. This has defeated the principle of fairness and equity that every member should be served with equality.

More importantly, there was no proper loan repayment scheduling to correctly determine the principal, interest amounts and the term on when the loan should be fully settled.

During the year 2017, the Central Bank has initiated and devised a loan repayment schedule guide as the basis to support the sector and provided one-on-one training to ensure credit unions adopt the schedule when appraising their loan applications.

4.4 Liquidity Distress

The sector continues to experience cashflow problems to finance and sustain its operation due to poor liquidity management. It was observed that the two underlying causes were in relation to liability mismatch when credit extended to members were on longer term and some of the members funds were invested in fixed assets which generated low cash flows as expected. The other cause was in relation to non-performing loans (NPLs) particularly with unsecure loans, which were not secured by insufficient savings. As a result, there was no recovery of the debts as there was little effort for collection, limiting the chances of recovering the funds in doubt.

4.5 Operational Deficiency

The sector does not have proper accounting and management information system. The system is particularly useful for the proper administration of membership record and for timely production of information for decision-making and dissemination to members.

The absence of an adequate system for the sector also contributed to weak internal controls to ensure effective monitoring and reporting system is in place. This weakness can expose the sector to other operational deficiencies such as fraud and abuse of members' funds. It is extremely important that individual credit unions put in place robust systems and adequate controls to effectively manage members' funds.

APPENDICES

Appendix 1: Banking Sector

Table 1.1 Banking Sector Financial Soundness Indicators					
	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Capital Adequacy					
Total Regulatory Capital to RWAs (CAR) >15%	32.4%	31.6%	31.2%	32.3%	35.1%
Net NPL to Capital & Reserves	12.0%	8.1%	7.3%	6.6%	11.5%
Asset Quality					
NPL to Total Gross Loans <2% to <8%	7.0%	4.7%	4.1%	3.8%	6.1%
Specific LLP to NPLs (Coverage Ratio) >20% to <100%	22.8%	26.0%	29.5%	31.2%	19.7%
Earnings & Profitability					
Return on Assets (ROA) >2% to <6%	4.0%	3.3%	3.0%	3.5%	3.9%
Return on Equity (ROE)	23.3%	20.0%	17.6%	22.7%	23.3%
Net-interest Income to Gross Income	54.3%	56.7%	55.0%	56.3%	55.0%
Cost to Income Ratio >35% to <65%	52.8%	51.6%	50.2%	47.1%	47.2%
Non-interest Income to Gross Income	45.7%	43.3%	45.0%	43.7%	45.0%
Personnel Expenses to Noninterest Expenses	31.1%	30.4%	31.1%	31.1%	34.0%
Effective interest rate-loans					
Interest income /total gross loans	12.7%	11.9%	9.9%	11.1%	11.1%
Effective interest rate-deposits					
Interest expense/total deposits	0.2%	0.3%	0.3%	0.3%	0.3%
interest spread	12.4%	11.6%	9.7%	10.8%	10.8%
Liquidity					
Deposits to Loans Ratio >70% to < 150%	172.9%	153.6%	148.6%	145.6%	146.7%
Liquid Assets to Total Assets Ratio	40.6%	38.0%	33.5%	38.1%	38.6%
Liquid Assets to Short term Liabilities > 30% to <70%	56.5%	51.7%	46.2%	53.3%	55.5%
Sensitivity to Market Risks					
Net open position in foreign exchange to capital <25%	8.7%	11.1%	7.9%	3.6%	3.8%

Source: CBSI

Table 1.2 Banking Sector Income Statement (SBD million)

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
1. Interest income	182.6	200.5	194.5	243.6	258.1
2. Interest expense	7.9	8.8	10.1	12.4	15.1
3. Net interest income (= 1 - 2)	174.7	191.7	184.4	231.2	243
4. Noninterest income	146.9	146.3	151.1	179.7	199
(i) Fees and commissions receivable	33.5	28.0	20.9	24.1	26.7
(ii) Gains or losses on financial instruments	98.1	96.0	103.0	124.4	147.7
(iv) Other income	15.3	22.3	27.2	31.2	24.6
5. Gross income (= 3 + 4)	321.6	338.0	335.5	410.9	442
6. Noninterest expenses	169.8	174.3	168.3	193.6	208.8
(i) Personnel costs	52.8	53.0	52.4	60.2	70.9
(ii) Other expenses	117.0	121.3	115.9	133.4	137.9
7. Provisions (net)	4.3	27.3	34.5	29.6	21.5
(i) Loan loss provisions	4.1	26.8	34.5	28.6	21.6
(ii) Other financial asset provisions	0.1	0.5	0.0	1.0	-0.1
8. Net income (before extraordinary items and taxes) (= 5 - (6 + 7))	147.5	136.4	132.6	187.7	211.7
9. Extraordinary items	0.0	0.0	0.0	0.0	0
10. Income tax	53.3	49.7	43.3	60.0	76
11. Net income after extraordinary items and taxes (= 8 - (9 +10))	94.2	86.7	89.3	127.7	135.7

Source: CBSI

Table 1.3 Banking Sector Balance Sheet (SBD million)

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
12. Total assets (= 13 + 14 = 25)	4,022.7	4,141.2	4,812.6	5,397.5	5,671.0
13. Nonfinancial assets	97.5	113.0	141.2	135.8	160.9
14. Financial assets (= 15 to 18)	3,925.2	4,028.2	4,671.5	5,261.8	5,510.2
15. Cash and deposits	1,710.6	1,622.3	1,796.5	2,193.4	2,297.2
16. Loans (after specific provisions)	1,416.5	1,668.4	1,935.7	2,165.4	2,297.6
(i) Gross loans	1,439.6	1,688.9	1,959.6	2,191.7	2,325.4
(ii) Specific provisions	23.1	20.6	23.9	26.3	27.8
17. Debt securities	647.3	653.7	724.5	768.1	766.3
18. Other assets	150.8	83.8	214.8	134.9	149.1
19. Liabilities (= 23 + 24)	3,369.3	3,420.5	4,028.1	4,519.9	4,686.9
20. Cash and deposits	3,178.7	3,297.1	3,836.7	4,288.7	4,431.7
21. Borrowings	5.1	4.0	3.1	4.9	2.3
22. Other liabilities	185.5	119.4	188.3	226.3	252.9
23. Debt (= 20+ 21 + 22)	3,369.3	3,420.5	4,028.1	4,519.9	4,686.9
24. Capital and reserves	653.4	720.7	784.5	877.7	984.1
25. Balance sheet total (= 23 + 30 = 14)	4,022.7	4,141.2	4,812.6	5,397.5	5,671.0

Source: CBSI

APPENDICES

Appendix 2: Superannuation Sector

Table 2.1 Superannuation Sector Financial Soundness Indicators

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Total Superannuation Sector Assets					
Total Assets to Total Finanical system Assets Ratio	36.9%	38.1%	35.9%	35.2%	34.3%
Total Assets to Gross Domestic Product Ratio	33.1%	34.5%	34.4%	35.9%	36.8%
Capital Adequacy					
Total Capital & Reserves to Total Assets Ratio	26.9%	19.4%	15.0%	12.1%	9.1%
Asset Quality					
Substandard Investments to Total Investments Ratio	5.0%	3.0%	3.9%	3.8%	2.2%
Investment Assets to Total Assets Ratio	85.1%	90.2%	85.3%	80.5%	85.5%
Earnings & Profitability					
Return on Assets (ROA)	0.0%	0.3%	1.4%	0.1%	0.1%
Cost to Income Ratio	96.9%	59.5%	52.4%	128.2%	92.0%
Liquidity					
Liquid (core) Assets to Total Assets Ratio< 50%	6.6%	1.9%	9.4%	13.3%	10.6%
Liquid Assets to Short term Liabilities Ratio	91.8%	22.3%	99.5%	141.8%	84.6%

Source: CBSI; Restated

Notes

1/ Core liquid assets include cash and demand deposits held with the banking sector

2/ Short term liabilities include total value of contributions owed to members aged 50 and above

Table 2.2: Superannuation Sector Income Statement (SBD million)

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
1. Interest income	164.2	131.2	141.3	174.4	147.9
2. Interest expense					
3. Net interest income (= 1 - 2)	164.2	131.2	141.3	174.4	147.9
4. Noninterest income	673.8	50.4	74.5	84.0	-22.1
(i) Fees and commissions receivable	4.7	4.6	2.1	3.5	2.9
(ii) Gains or losses on financial instruments	667.7	29.9	70.5	79.8	-25.7
(iii) Other income	1.4	15.8	1.9	0.8	0.7
5. Gross income (= 3 + 4)	838.0	181.6	215.7	258.4	125.8
6. Noninterest expenses	66.0	74.6	73.3	87.7	79.6
(i) Personnel costs	9.4	10.2	11.0	11.9	14.9
(ii) Other expenses	56.6	64.4	62.4	75.8	64.7
7. Provisions (net)	0.0	8.0	0.0	0.0	0.6
(i) Loan loss provisions	0.0	8.0	0.0	0.0	0.6
(ii) Other financial asset provisions					
8. Net income (before extraordinary items and taxes) (= 5 - (6 + 7))	772.0	99.0	142.4	170.7	45.6
9. Extraordinary items					
10. Income tax					
11. Net income after extraordinary items and taxes (= 8 - (9 +10))	772.0	99.0	142.4	170.7	45.6
12. Dividends paid	248.7	243.2	189.5	220.9	133.0
13. Retained earnings (= 11 - 12)	523.2	-144.2	-47.1	-50.3	-87.4

Source: CBSI

Table 2.3: Superannuation Sector Balance Sheet (SBD million)

		Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
14.	Total assets (= 15 + 16 = 29)	2,554.9	2,776.8	2,888.7	3,162.9	3,255.5
15.	Nonfinancial assets, Net of Acc Depn	297.9	342.2	352.6	355.5	405.2
16.	Financial assets (= 17 to 21)	2,257.0	2,434.6	2,536.1	2,807.4	2,850.3
17.	Currency and deposits	641.7	682.2	884.1	1,023.9	993.4
18.	Loans (after specific provisions)	208.9	233.3	185.0	213.7	253.3
	(i) Gross loans	104.4	116.7	92.5	106.8	126.7
	(ii) Specific provisions	0.0	0.0	0.0	0.0	0.0
19.	Debt securities	106.6	86.0	68.1	42.9	194.5
20.	Shares and other equity	1,182.9	1,285.3	1,315.5	1,400.0	1,347.3
21.	Other assets	116.9	147.7	83.4	126.9	61.8
23.	Liabilities (= 27 + 28)	1,791.9	2,144.6	2,376.5	2,686.0	2,844.8
24.	Loans	0.0	4.1	0.1	1.1	0.0
25	Members contributions	1,763.1	2,099.4	2,334.3	2,620.9	2,780.9
26.	Other liabilities	28.8	41.1	42.0	64.1	63.9
27.	Debt (= 24 + 25 + 26)	1,791.9	2,144.6	2,376.5	2,686.0	2,844.8
28.	Capital and reserves	658.6	515.5	419.7	370.1	284.0
29.	Balance sheet total (= 23 + 28 = 14)	2,450.4	2,660.1	2,796.2	3,056.1	3,128.9

Source: CBSI

APPENDICES

Appendix 3: Insurance Sector

Table 3.1 Insurance Sector Financial Soundness Indicators	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Capital adequacy					
Net premium to capital	70.7%	74.8%	84.7%	94.7%	74.4%
Capital & reserves to total assets	61.0%	58.8%	55.7%	42.4%	46.5%
Asset quality					
Debtors to total assets	20.0%	25.7%	24.9%	28.5%	24.5%
Debtors to (gross premiums + reinsurance recoveries)	35.5%	44.7%	39.5%	52.2%	45.8%
Reinsurance and actuaries issues					
Risk retention ratio (net premium to gross premium)	77.1%	76.3%	75.5%	74.1%	65.8%
Earnings & profitability					
Loss ratio (net claims to net premiums)	14.5%	19.1%	19.2%	20.8%	16.8%
Expense ratio (expenses to net premiums)	17.9%	25.0%	42.2%	31.8%	32.4%
Combine ratio (net claims and expenses to net premiums)	32.4%	44.1%	61.4%	52.6%	49.2%
Return on equity (ROE)	47.7%	42.1%	35.7%	32.4%	45.8%
Liquidity					
Liquid assets to short term liabilities	225.9%	190.3%	158.8%	115.5%	134.3%

Source: CBSI; Restated

Table 3.2 : Insurance Sector Income Statement (SBD million)	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
1. Total premium	68.9	72.7	71.0	77.8	65.0
2. Outward reinsurance	15.8	17.2	17.4	20.1	22.2
3. Premium net of reinsurance (= 1 - 2)	53.1	55.5	53.6	57.6	42.8
4. Unearned premium reserves	2.0	0.7	-4.2	5.5	-7.4
5. Net earned premium (= 3 - 4)	51.1	54.8	57.7	52.1	50.2
6. Gross claims expense	8.1	10.5	10.6	12.5	8.3
7. Total recoveries	0.4	-0.1	0.4	0.5	1.1
8. Net claims expenses (= 6 - 7)	7.7	10.6	10.3	12.0	7.2
9. Commission Expense	1.2	2.4	3.5	3.5	3.5
10. Total underwriting expenses (= 8 + 9)	8.9	13.0	13.8	15.5	8.7
11. Underwriting Results (= 5 - 10)	42.2	41.8	43.9	36.7	41.5
12. Other operating income	0.4	0.3	0.2	0.2	0.1
13. Other operating expenses or management expenses	8.3	11.5	19.1	14.8	10.3
14. Net Profit (Loss) Before Tax (= 11 + 12 - 13	34.3	30.6	25.1	22.1	31.3
15. Income tax or provisions	9.7	8.9	7.2	5.2	6.2
16. Net Income (Loss) End of Current Period (=14 - 15)	24.5	21.7	17.8	16.9	25.1

Source: CBSI, Restated

Table 3.3: Insurance Sector Balance Sheet (SBD million)

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
17. Total Assets (= 18 + 19)	123.1	126.1	113.4	143.5	123.5
18. Nonfinancial assets	0.9	3.3	1.9	5.5	2.3
19. Financial assets (= 20 to 26)	122.2	122.8	111.5	138.0	121.1
20. Currency and deposits	79.6	73.0	62.5	75.7	38.4
21. Loans	0.0	0.0	0.0	0.0	0.0
22. Debt securities	14.5	16.7	17.5	16.0	46.5
23. Insurance technical reserves	24.6	32.5	28.2	40.9	30.3
24. Other assets	3.5	0.7	3.3	5.4	6.0
25. Liabilities(= 10+ 11)	48.0	52.0	50.2	82.6	66.0
26. Insurance technical reserves	41.6	47.1	50.4	79.4	63.2
27. Other liabilities	6.3	4.8	-0.2	3.3	2.9
28. Capital and reserves	75.1	74.1	63.2	60.8	57.5
29. Balance Sheet Total (= 25+ 28 = 17)	123.1	126.1	113.4	143.5	123.5

Source: CBSI, Restated

Notes:

1/ Insurance technical reserves on the asset side include premium receivables, defferred reinsurance expnses, and other recoverables.

2/ Insurance technical reserves on the liabilities side include commissionpayables, unearned premiums, and outstanding claims.

APPENDICES

Appendix 4: Credit Union Sector

Table 4.1: Summary of Credit Union Sector Financial Perfromance and Soundness Indicators

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17
Balance Sheet (SBD million)					
Total Loans	36.1	37.1	40.1	40.5	43.1
Total Assets	50.6	52.6	58.4	61.4	63.2
Total Deposits/Savings	37.1	39.6	48.1	45.7	49.2
Total Share Capital	13.3	13.0	10.2	10.0	9.3
Income Statement (SBD million)					
Income	5.3	5.3	4.8	5.5	4.9
Expenses	2.6	2.3	2.1	3.2	2.2
Net Surplus (Loss)	2.7	3	2.7	2.3	2.7
Statistics					
Membership	5,700	6,124	6,232	6,089	6,253
No. of reporting Cus	10	10	10	10	10
Indicators					
ROA	5.3%	5.7%	4.6%	3.7%	4.3%
Loans to assets	71.3%	70.5%	68.7%	66.0%	68.2%
ROE	20.3%	23.1%	26.5%	23.0%	29.0%
Self Efficiency Ratio	203.8%	230.4%	228.6%	171.9%	222.7%

Source: CBSI