

## *Development in Banking Supervision*

**By Simon Tiwok 1 - Bank Supervisor**

With innovation and changes happening apace in the financial industry, banking supervision continues to play a vital role in the international financial architecture. As banks face an ever-changing environment and commensurate risk, relevant and up-to-date prudential guidance and standards remain critical to maintain the safety and soundness of individual banks as well as the stability of the global financial system.

Over the years, the world financial system experienced a number of important challenges and major shocks such as the Asian financial crisis and the event of September 11. Global regulatory bodies including, the Basel Committee on Banking Supervision, OECD and the Financial Action Task Force (FATF) continue to develop and promote fundamental policy guideline principles, both at national and international levels, to promote the stability of banking and other financial institutions, encourage competitive equality among them and combat money laundering and terrorist financing.

The Vanuatu banking system is made up of both onshore and offshore banking institutions. The Reserve Bank of Vanuatu (the Bank) has the supervisory oversight of domestic, and more recently offshore (or international) banks and the Vanuatu National Provident Fund. The Bank's role has evolved overtime in response to domestic and international developments and requirements. The Bank's supervisory role is founded on the need to maintain a stable and sound banking system. A sound banking system is in the interest of depositors and investors alike and also important for the maintenance of macroeconomic stability in the economy.

The Bank also has the role of promoting financial conditions conducive to the economic development of Vanuatu. Some recent developments in Vanuatu, particularly in relation to offshore banks need to be seen against this background. The Reserve Bank ensures that regulatory arrangements covering banks that are licensed by Vanuatu are consistent with international best practices.

The supervisory framework for banks licensed to operate in or from within Vanuatu is consistent with international standards applied in other countries that offer domestic and offshore banking services. The Reserve Bank has the power to license banks, set rules (prudential guidelines), issue directives, collect and analysis statistical data, conduct on-site inspections and regular prudential consultation with senior management with the supervised institutions to ensure that banks and other supervised financial institutions are managed in a prudent manner. With the events of September 11, the Reserve Bank, like other supervisory authorities, has taken a more active role in ensuring that banks have in place policies and procedures to combat money laundering. The Bank, in conjunction with Vanuatu's Financial Intelligence Unit (FIU) has been conducting on-site inspections of Vanuatu's domestic banks and offshore banks licensed in Vanuatu. Such measures are necessary to ensure that Vanuatu is not seen as a safe haven for money launderers or those involved in the financing of terrorism.

In late 2003, the Bank assumed supervisory responsibility for the Vanuatu National Provident Fund (VMPF). This reflects the importance of the VMPF to the economy and stability of the financial system.

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Since independence, the supervision of banks in Vanuatu has been shared between the Reserve Bank of Vanuatu and the Vanuatu Financial Services Commission (VFSC) under the auspices of the Banking Act [CAP 63]. The arrangement was unsatisfactory, particularly in relation to the supervision of domestic banks, as no one agency was in a position to adequately supervise the activities of domestic banks. The inadequacies of the arrangements were highlighted with the failure of a domestic bank, Olilian Bank, in 1996, and the inadequate management of the National Bank of Vanuatu. The failure of Olilian Bank resulted in depositors losing their funds.

Following this failure, and in response to increasing financial turmoil with the onset of the Asian financial crises, the Government decided to give the Reserve Bank supervisory responsibility for domestic banks while the supervisory responsibility for offshore banks would be given to the Financial Services Commission. To effect this change in the supervisory arrangements it was necessary to enact key enabling legislation; the Government agreed to the passage of this key legislation. In relation to the supervision of domestic banks, the Financial Institutions Act, developed in consultation with domestic banks operating in Vanuatu, was passed in 1999. The Act provided a sound basis for the Reserve Bank to supervise domestic banks in Vanuatu. In November 2002, the Act was amended to give the Reserve Bank additional powers to ensure that people who own, direct and manage the affairs of banks are fit and proper people to hold such important positions. If the Bank determines that a person is not fit or proper to be involved in the management of bank, it can direct that bank to remove that person from office.

However, legislation that would provide for the effective supervision of offshore banks was not passed and the efforts of the Vanuatu Financial Services Commission to effectively supervise the activities of offshore banks were severely hampered by the dual problems of inadequate legislation and limited capacity. To address these problems, the Government decided that supervisory responsibility for all offshore banking activities should be transferred to the Reserve Bank. The decision to make the Bank the regulator for all banks reflects the fact that the expected standards of supervision are precisely the same for both domestic and offshore banks, and that a suitable framework already exists within the Reserve Bank.

With the enactment of the International Banking Act No 4 of 2002 (the Act), which took effect in January 1, 2003, the RBV was given supervisory oversight for the offshore banking sector. The International Banking Act included a number of requirements to ensure that Vanuatu's reputation as an offshore centre remains in tack.

The Act introduced several new requirements that are consistent with international standards. One of the more significant requirements is that offshore banks in Vanuatu are required to maintain a physical presence and have a mind and management in Vanuatu. That is, banks must have, at the minimum, an office and employ staff in Vanuatu and must have full time management and directors residing in Vanuatu. The resident director is expected to conduct the day-to-day operations of the bank from the office in Vanuatu. This decision reflects international concerns about banks that have no physical presence; these so called 'Shell Banks' could not be subject to adequate supervision as there were no staffs or records in the jurisdiction. The continued existence of 'shell banks' could leave Vanuatu open to ~~abuse by money launderers and those involved in the financing of terrorism.~~ The physical presence requirement enables easy access to financial data for analysis purposes and effective physical supervision.

# Banking Legislation in Vanuatu

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In addition to responding to international concerns, the development of Vanuatu's offshore finance centre is seen as a vehicle for economic development. Previously, Vanuatu could be described as a "name plate" offshore financial centre that provided a place for a bank to be established. Such centers can be described as *notional* finance centers as the institutions operating from there are little more than 'brass plates' that add limited value to the economy and tend to contribute to less than 10 percent to economic growth. Vanuatu wants to become a *functional* offshore finance centre if the offshore centre is to truly become a vehicle for the wider economic benefit of Vanuatu.

Over the years, it was hard to accurately determine the size of contribution of the offshore banks to Vanuatu's economy, though the entire offshore finance center contribution to Government revenue is very limited. A recent assessment funded by the Pacific Islands Forum Secretariat at the request of the government of Vanuatu, in mid 2004, estimated that the entire offshore industry<sup>iv</sup> represented around 9 percent of GDP or roughly 5.5 percent of government revenues. It was also estimated that the industry employs around 212 personnel of whom 163 are locals. This figure equates to 1.5 percent of the formal sector employment.

Another important aspect of the International Banking Act is the requirement that existing banks re-apply to the Reserve Bank. The implementation of the Act was taken as an opportunity for institutions to upgrade their current standards of integrity and to require remaining institutions to reach proper levels of financial standing. At the implementation of the Act, 9 existing offshore banks re-applied to the Reserve Bank to continue undertaking international banking business from Vanuatu under the new arrangements.

The Act also requires that offshore banks maintain a minimum amount of capital of USD0.5 million. Under previous supervisory requirements the VFSC requested that offshore banks maintain capital of USD150 000 however it had no supervisory power to enforce this 'requirement'. Under the new supervisory arrangements, a bank capital requirement is determined in reference to the nature of business and risks the bank undertakes. As the level of business increases so will the level of capital required to support the business. Similar capital adequacy requirements are applied to Vanuatu's locally incorporated domestic banks.

With the introduction of the new Act, the decision was also taken to revise the level of fees paid by offshore banks. The annual licensing fee paid by offshore banks in Vanuatu had remained unchanged for 20 years and was low in comparison to fees charged in other offshore jurisdictions. By enhancing supervisory oversight of the offshore banks, the Reserve Bank endeavors to protect Vanuatu's reputation. The Bank has had positive feedback from a number of existing participants who see the new Act as giving Vanuatu increased credibility and this will therefore allow them to increase the scope and nature of their activities.

## **Anti-Money Laundering**

In Vanuatu, the Financial Intelligence Unit (FIU) of the State Law Office has the prime responsibility for Vanuatu's anti-money laundering efforts. The Reserve Bank maintains close liaison with the State Law Office. The Bank reviewed and holds up to date copies of the domestic and offshore banks' policy documents covering anti-money laundering. As part of its normal supervisory role, the Reserve Bank discusses aspects of these policies and ~~compliance with the banks. In an effort to combat money laundering and the financing of~~ terrorism, the Reserve Bank issued a number of policy guidelines covering anti-money laundering.

# *Anti-Money Laundering*

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Vanuatu enacted the Financial Transactions Reporting Act No. 33 (the Act) in 2000. The Act established a framework that covers various aspects of money laundering and the role of participants in the financial system in relation to the combating of money laundering. The definition of financial institutions covered by the Act is exceedingly wide and has been expanded by Ministerial Order.

## ***The salient features of the Act include:***

- the requirement that all financial institutions to report any transaction that it has reasonable grounds to suspect may be suspicious and/or may be related to money laundering
- the requirement for financial institutions to keep records for a period of six years to enable the transaction to be readily reconstructed by the Financial Intelligence Unit
- the requirement for financial institution to verify the customer's identity
- the Act forbids financial institutions to open or operate anonymous accounts
- the Act seeks to ensure that financial institutions take preventative measures to identify money laundering (e.g. establishing internal procedures, staff training)
- the requirement that all financial institutions provide the Financial Intelligence Unit with copies of their internal procedures
- the Act established the Financial Intelligence Unit (FIU) within the State Law Office. The FIU receives suspicious transactions reports and provides copies of such reports to the Reserve Bank of Vanuatu and the Public Prosecutor's Office. If the Attorney General considers it appropriate, reports are also given to the Financial Services Commission (FSC) and law enforcement or supervisory bodies outside Vanuatu. The FIU can share information with bodies outside Vanuatu without the need to enter into treaties and/or Memorandum of Understanding.
- the FIU also conducts on-site inspections to financial institutions to ensure compliance with the Act and generally provides assistance to supervisory bodies, both domestic and international, in relation to the detection, investigation and prosecution of a money laundering offence;
- the Act allows the FIU to obtain search warrants to enter premises and remove documents;
- the Act imposes a range of fines, including imprisonment, for failure to comply with the Act.

# *Suppression of Terrorist Financing*

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In addition to the measures taken by the Reserve Bank, a range of legislative measures dealing with money laundering and the financing of terrorism have also been enacted by the Government. The legislations include:

- the International Convention for the Suppression of Financing of Terrorism Act No. 2 of 2002.
- the Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances Act No. 27 of 2001.
- the repeal of the Serious Offences (Confiscation of Proceeds) Act and its replacement with the Proceeds of Crime Act in November 2002. The new Act includes full forfeiture and restraining, monitoring and production powers. The financing of terrorism is an offense under this Act.
- the repeal of Extradition Act [CAP 199] in November 2002 and its replacement with the Extradition Act No 16 of 2002. The new Act includes money laundering within the scope of extraditable offences.
- the United Nations Act No. 1 of 2002 was passed in November 2002. This Act gives the Prime Minister the power to make regulations to implement UN Security resolutions.
- the Financial Transactions Reporting Act was amended in November 2002 to include suspicious transaction reporting where financing of terrorism is suspected.

The Financial Transactions Reporting Act is currently being amended to strengthen anti-money laundering legislation in Vanuatu to ensure consistency with international requirements, such as the Financial Actions Task Force (FATF) 40 Recommendations on money laundering and the financing of terrorism. It is envisaged that amendments to this Act will be introduced in Parliament sometimes before early 2006.

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*i. The Basel Committee on Bank Supervision was established in 1974 to promote the supervision of internationally active banks. Lately, it has also concerned itself with additional issues such as "Know Your Customer" (KYC) and Anti-Money Laundering (AML)*

*ii. The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing*

*iii. See article "Brief History of Banking Supervision" for more details on Prudential Policy Guidelines.*

*iv. The assessment covered the following offshore companies: shipping, banking, insurance and trusts.*