

Financial Stability

Financial Sector

The Reserve Bank continued to be responsible for the promotion of a sound and efficient financial system. This is pursued through the licensing, regulating and supervising of financial institutions, which are the banks and authorised foreign exchange dealers. The NRBT (Amendment) Act 2014 extended the mandate of the Reserve Bank to the licencing and supervision of non-bank financial institutions (NBFIs). Separate legislations are being developed for the licencing and supervision of the individual NBFIs.

There are now 5 banks licensed to operate in Tonga.

Banking Services in Tonga					
Banks	ANZ	WBOT	MBf	TDB	PICB
Branches (including Head Office at Nuku'alofa)	3	2	2	8	1
ATMs	9	8	-	-	-
EFTPOS	150	16	-	-	-
Instore Facilities					
Internet Banking	Yes	Yes	No	No	No
MoneyGram Agent	No	Yes	Yes	No	No
Money Transfer Card	Yes	Yes	No	No	No
Other Services	Insurance Agent (NPI)		Business advisory services, Microfinance		

All banks maintained their head offices in Tongatapu. The Westpac Bank of Tonga and MBf Bank Limited maintained their branches in Vava'u. The ANZ Bank also maintained its sub-branch in Vava'u. TDB continued to be the only bank serving all the outer islands of Ha'apai, Vava'u and 'Eua and the outermost islands of Niuatoputapu and Niuafo'ou. TDB also has two other branches in Tongatapu located in Tatakamotonga and

Nukunuku. TDB continued to be an agent for Westpac Bank of Tonga's customers in Ha'apai and 'Eua.

During the year, the banks maintained their current banking services, and rolled out some new banking services.

TDB is in the process of expanding its services to more commercial banking products. TDB introduced its cheque accounts and overdraft facilities in July 2014 and continued to provide business advisory services to its customers. In March 2015, TDB commenced offering deposits and withdrawal services on Saturdays. The expansion plan includes offering foreign exchange products which are scheduled to be launched in 2015/16. TDB also commenced administering the Government "Managed Fund" loan scheme during the year, which is a low interest rate on-lent facility ranging from 1% to 4% to support primarily the growth sectors and education.

In early 2015, the Reserve Bank was informed of Westpac's plan to sell its shares to Bank of South Pacific (BSP) as part of a regional deal that involves Westpac banks in 5 Pacific Island countries including Tonga, Cook Islands, Samoa, Solomon Islands, and Vanuatu. The Board of Directors considered foremost the importance of the continuance of the banking services provided by Westpac, given this is the largest bank in Tonga, and the financial strength and credibility of the BSP. The Board therefore approved the sale of shares and the revocation of WBOT's bank licence and the simultaneous issuance of a new bank licence to BSP subject to conditions. The sale was targeted to be finalized by the 29th of May 2015 but was still outstanding at the end of the financial year due to delays from the other Pacific Island countries.

Financial System Supervision and Regulation

In 2014/15, the Reserve Bank continued to focus its supervisory activities of banks on reducing the vulnerability of the banking system to credit and liquidity risks. Even though liquidity is considered to be high, the ex-

cess liquidity in the system was slightly reduced by the positive annual credit growth of 11.4% over the year. The monitoring of the banks' credit risk management systems and recovery process continued in order to ensure that the declining trend in non-performing loans is maintained.

The Reserve Bank continued to monitor the movements in banks' interest rates and spot checked banks' compliance with the requirements of Prudential Statement 4 on Disclosure of Interest rates and Fees & Charges, as these are common issues which directly affect the public. This also supports the consumer protection initiatives of the Reserve Bank. Interest rates have declined over the year, with the weighted average interest rate spread narrowing to a record low of 5.95% in June 2015 compared with 6.54% in June 2014. This decline largely reflects the high liquidity in the banking system. In addition, banks continue to offer lower rates to selective good customers while the published interest rates on loans remained the same. Deposit rates further declined over the year by up to 1% mainly for time deposit rates, compared to a reduction of up to 2% last year.

The Reserve Bank also focused on enhanced supervision of one bank. This included the issuance of three directives of which one is still in force under Section 37(1)(a) of the Financial Institutions Act and imposing of special requirements to address the high liquidity and operational risks of this bank.

Onsite examination of banks continues to be one of the core parts of the Reserve Bank's supervisory framework. The Reserve Bank examination team conducted an onsite visit to one bank in May 2015, together with the assistance of a technical expert funded by the IMF PFTAC office, to verify the bank's compliance with the Reserve Bank requirements as well as check on the progress of addressing the recommendations raised in previous onsite visits. One scheduled visit was deferred to the next financial year given the Reserve Bank's other commitments. The Reserve Bank will continue its onsite examination cycle of a bank every 2 years in the next financial year.

The National Reserve Bank of Tonga [NRBT] (Amendment) Act 2014 and the Financial Institutions [FI] (Amendment) Act became effective in October 2014. The amendments were mainly to ensure the NRBT Act and FI Act are in line with international best bank-

ing practices that have been taken on by other regional central banks. The Reserve Bank is currently working with the assistance of PFTAC to incorporate the amendments of the NRBT Act and the FI Act in the Prudential Statements, as well as develop a new Prudential Statement for Operational Risk Management. There is ongoing collaboration with the banks to ensure that they comply with statutory and prudential requirements at all times, which includes spot checks and bilateral technical meetings.

Monthly bilateral meetings with the banks as well as bi-annual meetings with the Association of Banks in Tonga (ABT) were held during the year to obtain updates on the banks' strategies in light of the market developments to ensure they continue to operate prudently and in compliance with the Reserve Bank's requirements. Furthermore, the meetings discuss issues which would support a sound and stable financial system such as issues relating to asset quality, profitability, interest rates and liquidity in the banking system.

Banking System Financial Performance

The total assets of the banking system increased by \$47.6 million (8.7%) to \$596 million in 2014/15. This was mainly due to a \$31.6 million (11.4%) growth in total loans and advances. The increase in loans largely reflected the increase in loans to businesses, particularly public enterprises, as well as private individuals during the year. Banks' Exchange Settlement Account (ESA) also rose by \$9.9 million (7.0%) during the year which reflects the increase in customers' deposits.

The credit growth over the year was attributed to factors such as lending to public enterprises and a major tourism project mainly by the two large banks. This was followed by the housing reconstructions in Ha'apai due to the recent cyclone disaster. Government also offered a low interest lending scheme through managed funds administered by TDB offering 1% and 4%. This scheme targeted specific key sectors in the economy such as agriculture, tourism, fishing and education.

At the end of the financial year 2014/15, the banks' outstanding loans portfolio comprised of loans to private businesses, including public enterprises, agriculture and fisheries (75.2%), private individuals (24.8% of

which 79% was for housing) compared with 70.2% and 29.8% (of which 92.3% was for housing) respectively in the previous year.

Total liabilities increased by \$39.6 million (9.4%) to \$461

Financial Sector Deposit Accounts

	2013/2014	2014/2015
Demand Deposits		
Number of Accounts	20,953	23,016
Value of Deposits (\$m)	143.3	155.8
Saving Deposits		
Number of Accounts	34,486	38,251
Value of Deposits (\$m)	53.7	61.2
Time Deposits		
Number of Accounts	2,236	2,062
Value of Deposits (\$m)	144.8	159.5
Deposit by Other Banks		
Value of Deposits (\$m)	15.6	17.5
Total Number of Accounts	57,675	63,329
Total Value of Deposits (\$m)	357.4	393.9

million. This was due mainly to a \$36.6 million (8.7%) growth in total deposits, compared with an increase of \$17.8 million (5.2%) in 2013/14. The significant increase in total deposits largely reflected an increase in Time Deposits. On the other hand, total provisions fell by \$4.1 million (18.9%), reflecting the write back of specific provisions for some impaired loans during the year.

The total number of deposit accounts reported by banks increased by 9.8% to 63,329 and the total value of deposits increased by 9.3% to \$393.9 million.

Profitability

The profitability of the total banking sector slightly decreased in the year ended June 2015 compared to the previous year. The total banking system showed an after-tax profit of \$12.1 million for the year ended June 2015, which is equivalent to 2.2% of average assets, compared with a profit of \$12.2 million for the previous year, which was equivalent to 2.3% of average assets.

The decline in profitability over the year was attributed mainly to a decrease in non-interest income to 3.7% of average total assets compared to 4.0% in the previous year. This reflects the decrease in net gain on foreign currency revaluation over the year.

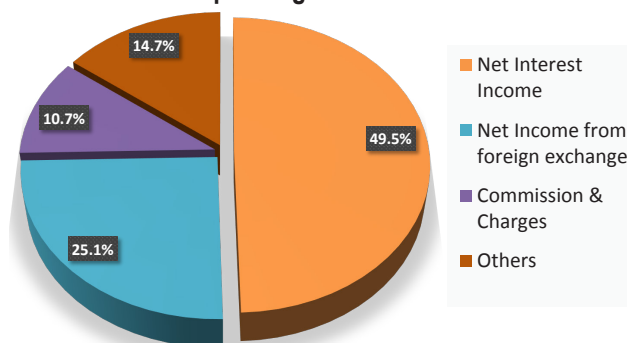
Financial Performance

	2013/14	2014/15
Pre-tax Net Profit (% average total assets)	2.9	2.9
After-tax Net Profit (% average total assets)	2.3	2.1
Total Operating Income (% average total assets)	7.8	7.7
Net Interest Income (% average total assets)	3.6	3.7
Non-interest Income (% average total assets)	3.9	3.7
Total Operating Expenses (% average total assets)	4.8	4.5
Consolidated Risk-weighted Capital Ratio (%)	39.8	39.0

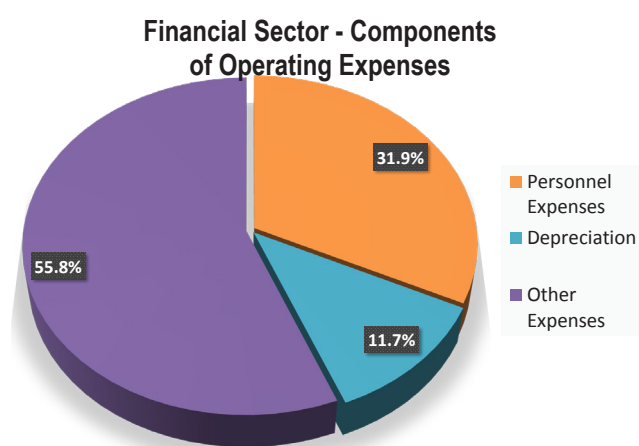
Total operating income as a percentage of average assets slightly decreased to 7.7% from 7.8% in the previous year. This declining trend reflects the larger magnitude of the growth in average assets which outweighed the improved income. The proportion of total operating income from net interest income increased to 51.8% in 2014/15 compared with 47.7% in 2013/14 and similarly the proportion of operating income from non-interest income decreased to 48.2% from 52.3% in the previous year. The decline in non-interest income reflects the decrease in net income from foreign exchange to 26.2% of average assets from 27.1% in the previous year.

Total operating expenses decreased to 4.5% of average assets in 2014/15, compared with 4.8% in 2013/14. This was mainly due to a decrease in other operating

Financial Sector - Components of Operating Income

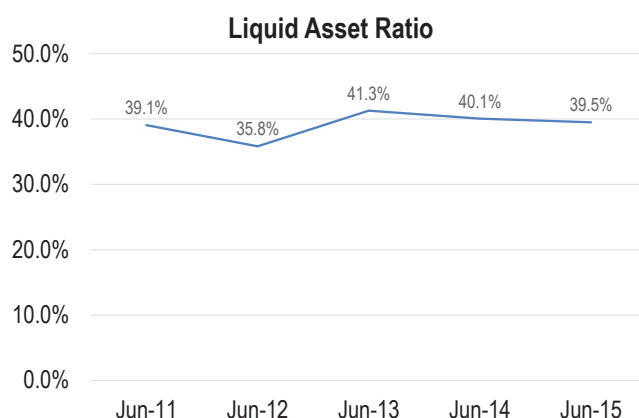


expenses over the year. The operating expenses of the banks comprised mainly of 31.9% personnel expenses, a decrease from 32.1% in the previous year reflecting the decrease in operating expenses due to banks streamlining their operational cost and a reduction in the number of staff during the year. Depreciation and amortization accounted for 11.7% of total administrative expenses and the balance of 55.8% was made up of the banks' other expenses for the daily operation needs which decreased from 59.3% in the previous year due mainly to lower outsourcing and management fees.



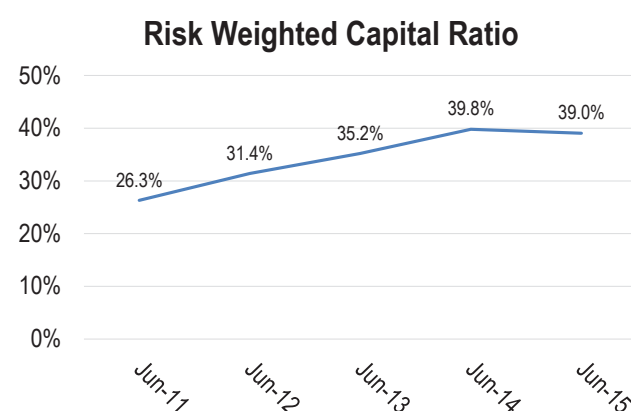
Liquidity

Liquidity in the banking system remained high during 2014/15 at comfortable levels. The increase in eligible liquid assets by \$13.3 million over the year contributed to the high liquidity but was partially offset by an increase in credit growth. Net loans as a proportion of deposits rose to 73.7% from 71.2% in June 2014. Furthermore, the Liquid Asset Ratio remained relatively stable at 40% over the year compared June 2014 and continued to remain well above the Reserve Bank's minimum requirement of 5%.



Capital

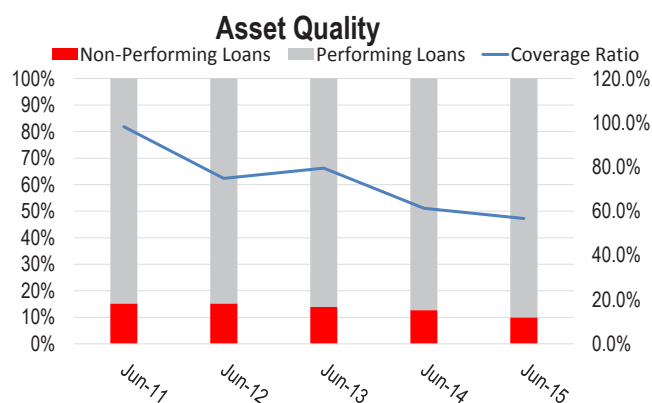
The capital position of the banking industry remained strong and above the minimum ratio required by the Reserve Bank of 15%. The consolidated risk weighted capital ratio for the banks slightly decreased to 39% at the end of June 2015, compared with 39.8% in the previous year, and has remained at this level since June 2014. The higher capital position was mainly attributed to the decision by the banks to not repatriate their profits and leave their annual profits in Tonga. Over the last 10 years some banks have not been repatriating but accumulating profits over the year.



Asset Quality

The overall quality of the banks' assets improved over the year to June 2015. Total non-performing loans decreased by \$4.4 million (12.5 %) to \$30.7 million compared to \$35.1 million in June 2014. This largely reflected loan write offs during the year. The ratio of non-performing loans to total loans also improved to 10.0% from 12.7% in June 2014. The total non-performing loans comprised of loans to businesses (54.4%), mainly the hotels and restaurants and wholesale and retail sectors, as well as housing for private individuals (22.9%).

Total provisions against loans fell by \$4.1 million (19.1%) to \$17.4 million which is in line with the decline in non-performing loans over the year. The coverage ratio of the non-performing loans by total loan loss reserves, therefore, declined to 56.7%, compared with 61.4% in June 2014. The Reserve Bank is working closely with banks to ensure the adequacy of provisions as well as the accurate reporting of security values.



Licencing and Supervision of Restricted Foreign Exchange Dealers

During the year, the Reserve Bank licensed 4 and registered 11 authorized restricted foreign exchange dealers. Three registered authorized restricted foreign exchange dealers ceased operation before the renewal of the authorized restricted foreign exchange dealers for 2015.

All foreign exchange dealers generally complied with the conditions of the license/registration which formed the basis for the Reserve Bank's approval of the renewal of 12 authorized restricted foreign exchange dealers for 2015. New conditions were imposed in 2015 which included the requirement for the foreign exchange dealer's overseas agents to be licensed with the appropriate licensing authority. This was mainly to provide assurance that the overseas agents are subject to similar licensing regime thereby reduce the risk of facilitating illicit flows through these foreign exchange dealers.

The Commercial Banks are licensed as authorized dealers under their banking license. Two of the commercial banks, namely WBOT and MBf Bank currently have agency arrangements with MoneyGram.

The coordinated efforts of the Reserve Bank and the Ministry of Commerce, Tourism and Labour continued to enhance compliance with the requirement for businesses that were conducting foreign exchange business without a license to apply for a license. The proposed amendments to the Foreign Exchange Control Act will include strengthening of the Reserve Bank's licensing and enforcement powers.

Compliance spot checks, training of the authorized foreign exchange dealers, stakeholder and quarterly meetings when required contributed to the improvement in the understanding and compliance with the conditions of license/ registration.

Financial Inclusion

During the year, the Reserve Bank became more active in its participation in the Alliance for Financial Inclusion (AFI) network in order to promote financial inclusion. Inclusive economic growth and improving access to financial services was crucial for poverty reduction and improving the people's standard of living.

The Reserve Bank participated in the AFI Global Policy Forum (GPF) and the Pacific Islands Working Group (PIWG) meeting in September 2014. This meeting agreed to convert the PIWG into a long-term regional initiative, known as the Pacific Island Regional Initiative (PIRI) to focus on addressing the challenges faced by the Pacific region of having the highest unbanked rates in the world due to geographical dispersed islands, low population density and underdeveloped physical and banking infrastructure. The inaugural launch and first meeting of the PIRI was held in Dili, Timor Leste in May 2015 which the Governor attended.

The Reserve Bank has been working closely with the Pacific Financial Inclusion Programme (PFIP), a Pacific-wide programme that is jointly managed by the UN Capital Development Fund (UNCDF) and the United Nations Development Programme (UNDP) and is also a partner agency of AFI, in providing technical and financial assistance to the Reserve Bank in progressing financial inclusion in Tonga. In March 2015, the first activity in the process of developing a National Financial Inclusion Strategy for Tonga was issuing the "Supply side survey" to all financial services providers in the Kingdom. The objective of this survey was to assess the level of access and availability of financial services to financial customers. Other activities are scheduled to be conducted later in the year with the assistance of AFI and the PFIP.

Payment System

The NRBT (Amendment) Act 2014 broadens the role of the Reserve Bank to include being exclusively responsible for the regulation, licensing, registration and oversight of payment, clearing and securities settlement systems. The Reserve Bank continued its discussions with the World Bank IFC during the year on assistance for enhancing the framework for the payment system oversight. The Reserve Bank's priority was to ensure the implications of the payment system reform are well understood by all stakeholders and that all stakeholders are ready for these reforms.

Meanwhile, the manual settlement system, involving the inter-bank cheque clearance that is conducted by the Settlement Unit on a daily basis is operating well.

Interbank Cheques Clearance

The Reserve Bank facilitates a daily clearance service for the commercial banks to ensure a safe and efficient clearing system. The commercial banks operating in Tonga have signed an interbank clearing agreement for the clearance of cheques on a daily basis. A total of 147,934 cheques were presented for clearance at the Reserve Bank during the financial year 2014/15, an increase of 11% from the previous year. The increase in the number of cheques being cleared may be attributed to the increase in economic activity over the year and during the month of June in relation to the Coronation celebrations. The clearance of cheques in the centre is running well and all participants are committed to settle their dues on time. Reflecting the high level of liquidity available in the domestic market, there were no special cheque clearances between the banks during the year.

Financial Intelligence Unit

The Reserve Bank is the Transaction Reporting Authority (TRA) established under the Money Laundering and Proceeds of Crime Act 2000 (MLPC Act). The TRA is vested with the function of a Financial Intelligence Unit (FIU) in ensuring the financial system is protected from money laundering and terrorist financing activities. This in turn supports the Reserve Bank's objective of promoting a safe and sound financial system. The FIU's role and functions prescribed under the MLPC Act includes policy formulation and enforcement.

During 2014/15, the FIU continued to implement the requirements of the MLPC 2010 legislative amendments and the recommendations from the 2010 Mutual Evaluation Report. In July 2014, the Inter-Agency Memorandum of Understanding (MOU) was signed by six government agencies including the FIU. Other agencies include Tonga Police, Ministry of Revenue & Customs, Ministry of Commerce, Tourism and Labour, Ministry of Foreign Affairs and Trade and the Attorney General's Office. The MOU facilitates, through information sharing, a framework at operational level where by which partner agencies will work together to effectively, perform their respective duties, investigate crime including money laundering and terrorist financing and prosecute criminal offenders.

The FIU's membership application to the Egmont Group progressed during the year. Membership benefits include improving the FIU's capacity to exchange information with foreign counterparts and access technical assistance and training provided for Egmont members. In October 2014, Egmont membership sponsors, Cook Islands FIU and Fiji FIU, visited the FIU to assess its operational standards. This review has indicated that there is a need for improved independence and operational autonomy of the FIU. In April 2015, the Board approved the renaming of the TRA unit as the FIU within the NRBT, to be solely responsible for implementing the prescribed functions of the TRA under the MLPC Act, and to be headed by a Director, so as to improve the FIU's independence.

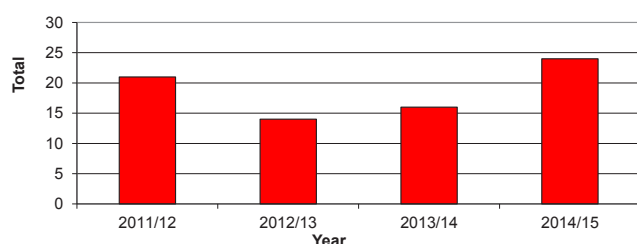
The improvement to the operational independence of the FIU and other recommendations from the Egmont Legal Working Group are included in the proposed amendments to the MLPC Act.

In May 2015, the FIU issued a Revised AML/CFT Guideline to all financial institutions and cash dealers. This replaced the first AML Guideline issued in 2006. The revision was to incorporate the requirements of the MLPC (Amendment) Act & Regulations 2010 and to also broaden the scope to include cash dealers, which were not previously covered.

The Reserve Bank also adopted its very first AML/CFT Policy developed by the FIU in May 2015. The purpose of this policy is to implement anti-money laundering and counter terrorist financing measures within the operations of the Reserve Bank.

In preparation for Tonga's second round of Mutual Evaluation, the FIU together with the Attorney General's Office coordinated a National Risk Assessment for Tonga with technical assistance from New Zealand in May 2015. This project is still in progress.

Total number of Suspicious Transactions Report



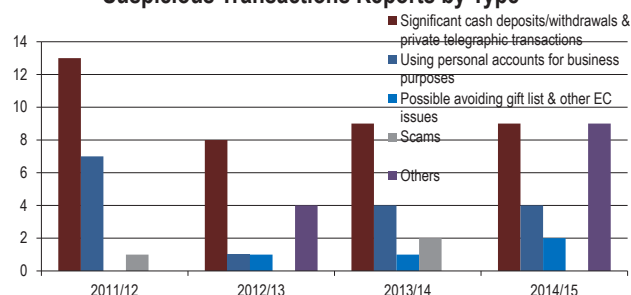
The FIU and the Foreign Exchange Dealer Unit conducted onsite visits to the authorized restricted foreign exchange dealers in the process of the annual review of their licenses. In response to the global banks' de-risking decisions, enhanced AML/CFT supervision and monitoring of the authorized restricted foreign exchange dealers continued in order to improve their AML/CFT compliance status. In addition, some of the autho-



AML Training - NRBT

rized restricted foreign exchange dealers consented to the FIU sharing its assessment of their AML/CFT compliance with one of the banks. This was to support the request made to banks to retain the foreign exchange dealers' bank accounts.

Suspicious Transactions Reports by Type



Furthermore, spot checks of banks' compliance with AML/CFT requirements such as the customer due diligence and ongoing monitoring of the accounts of Politically Exposed Persons (PEPs) were also conducted during the year. All reporting entities were generally compliant with the AML/CFT requirements.

The FIU received 24 STRs from the commercial banks and authorized restricted foreign exchange dealers during the year, representing an increase of 12% from the previous year. The increase in the STRs being reported is a result of improved awareness throughout the reporting entities as they become more mindful of the elements and indicators of suspicious transactions. The trainings provided by the FIU played a major role in increasing awareness and educating of reporting entities in reporting of STRs.

Summary of the number of STRs received by FIU since 2011

Year	2011/12	2012/13	2013/14	2014/15
Total STR received	21	14	16	24
Total STR passed to TCU	16	7	11	5
Total STR passed to IRD	14	0	1	6
Total STR passed to Immigration	2	0	1	0
Total STR passed to MCTL	0	0	1	0
Total Scams	1	0	2	0

The dominant STR indicator continued to be unusual significant cash deposits; withdrawals, foreign currency conversion or telegraphic transfers that were inconsistent with the customer's profile or the sources of funds were undetermined. Four (4) STRs were related to the usage of a personal account for conducting of business transactions, similar to the previous year. The remaining reports were related to third-party transactions and structured payments.

Subsequent to the analysis of the STRs, 5 of the 24 STRs were reported to the Police (TCU) for further investigations of possible money laundering and other serious offences. Six (6) STRs were disseminated to the Ministry of Revenue and Customs for possible tax evasion and non-compliance with Customs requirements.

The FIU conducted monthly and quarterly meetings with the law enforcement agencies to follow up feedback on the investigation of the STRs, and also share trends

from the analysis of reports collected by the FIU. The other reports collected by the FIU include the Currency Transaction Reports and Border Currency Reports.

The FIU conducted due diligence checks upon request by relevant agencies. To assist in its due diligence and background check function, the FIU subscribed to an AML screening solution with Acuity in September 2014.

The FIU continued to disseminate the terrorist list from the Office of Foreign Assets Control's (OFAC) of the United States Department of the Treasury of Specifically Designated Nationals (SDN) and the dissemination list of the Non-Cooperative Countries and Territories and countries that are subject to the Financial Action Task Force's public statements.