

National Reserve Bank of Tonga

# FINANCIAL STABILITY REPORT



December 2024





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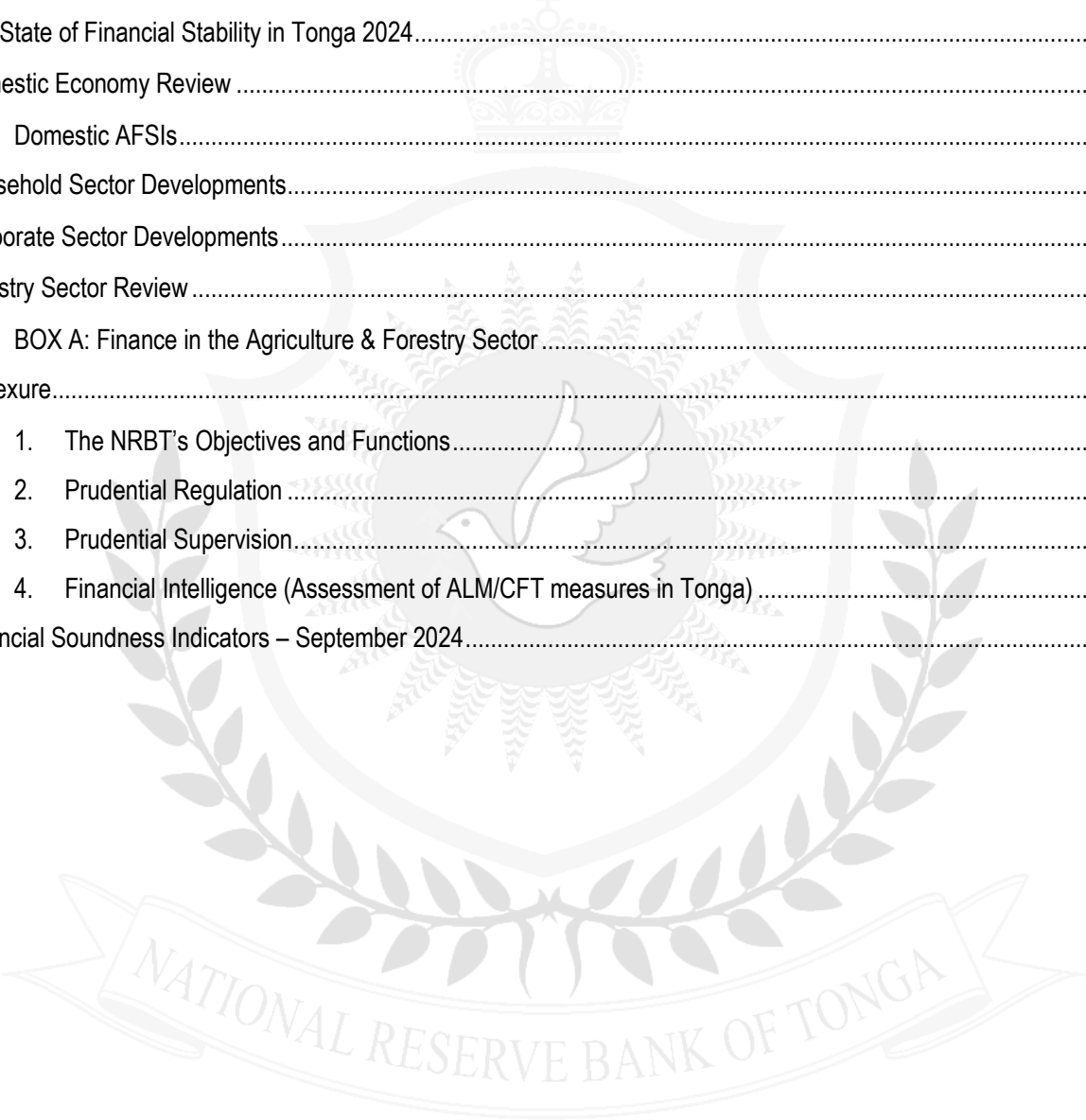
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## Abbreviations

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AE	Advanced Economies
AFSI	Aggregate Financial Stability Index
AML	Anti-Money Laundering
ANZ	Australia and New Zealand Banking Corporation Limited (Tonga)
AUD	Australian Dollar
BOP	Balance of Payments
BSP	Bank of South Pacific Group Limited (Tonga)
CAD	Current Account Deficit
CFT	Countering the Finance of Terrorism
CNY	Chinese Yuan
COLA	Cost of Living Allowance
EC	Eligible Capital
EMDE	Emerging Market & Developing Economies
EV	Electric Vehicle
EXIM	Export-Import Bank of China
FATF	Financial Action Task Force
FDX	Financial Development Index
FSI	Financial Soundness Index
FSU	Financial Stability Unit
FVI	Financial Vulnerability Index
GDP	Gross Domestic Product
GOT	Government of Tonga
HDI	Household Disposable Income
HH	Households
HT-HH	Hunga Tonga-Hunga Ha'apai
IMF	International Monetary Fund
IR	International Reserves
LA	Liquid Assets
LAR	Liquid Assets to Total Asset Ratio
LGD	Loss Given Default
LLP	Loan Loss Provisions
M2	Broad Money Supply (Tonga)

## National Reserve Bank of Tonga

Financial Stability Report | December 2024



MAFF	Ministry of Agriculture, Food & Forestry (Tonga)
MBF	MBf Bank Limited (Tonga)
MER	Mutual Evaluation Report
MFI	Micro-Financial Institutions
MOF	Ministry of Finance (Tonga)
MOR	Ministry of Revenue (Tonga)
NFA	Net Foreign Assets
NPL	Non-Performing Loans
NRBT	National Reserve Bank of Tonga
NZD	New Zealand Dollar
PALM	Pacific Australia Labour Mobility
PBD	People's Bank of China
PD	Probability of Default
PIF	Pacific Island Forum
PPP	Public Private Partnership
REER	Real Effective Exchange Rate (Tonga)
RER	Real Exchange Rate
RFB	Retirement Fund Board
RIR	Real Interest Rate
RSE	Recognised Seasonal Employer
SDR	Special Drawing Rights (IMF)
SPBD	South Pacific Business Development
TA	Total Assets
TDB	Tonga Development Bank
TNAC	Tongan National Agricultural Census
TPL	Tonga Power Limited
USD	U.S Dollar
VIX	Chicago Board Options Exchange Market Index

## Preface

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Financial stability remains at the core of the NRBT mission, as mandated by the National Reserve Bank of Tonga Act (2020) under its objectives and functions and reflected in its monthly banking sector developments reports. However, previous missions from the IMF have recommended that the Reserve Bank broaden its macro-prudential toolkit and adopt a more risk-based approach to data analysis. These steps would better support the Bank in achieving its overarching financial stability objectives.

Although the Reserve Bank's FSU is still in its early stages, with many macro-prudential tools under development, the Bank has decided to initiate a bi-annual Financial Stability Review. This report marks the beginning of the Bank's effort to present its own assessment of the current state and key risks within the Tongan financial system. The NRBT intends to enhance its analysis in future editions as new data, methods, and tools are introduced.

The release of this review is particularly timely, given the recent public concerns over the deterioration in some of Tonga's core financial soundness indicators such as non-performing loans and the liquid assets-to-total assets ratio as well as the international attention Tonga's public debt burden has harnessed. This report provides the Reserve Bank's analysis of these issues and outlines the measures taken to mitigate risks to the broader financial system, ensuring stability is maintained.

This initial review focuses primarily on the Tongan banking sector, which includes four commercial banks: BSP, ANZ, MBF, and TDB: the latter is also the sole government-funded financial institution. Together, these four banks account for 87 percent of total private credit in Tonga. Additionally, in the non-bank sector, the RFB—one of Tonga's two domestic pension funds—provides loans and advances to its members (public employees), accounting for another 10 percent of total credit. The remaining credit, of which there is available data, is provided by the sole microfinance operator, SPBD. While there are 103 registered moneylenders in Tonga, the Reserve Bank currently does not receive regular data from these operators, limiting its ability to assess their impact. Due to confidentiality, this report will not provide institution-specific data, despite one bank being under close surveillance by the Reserve Bank.

## Acknowledgements

The National Reserve Bank of Tonga would like to acknowledge the cooperation of the Tongan financial institutions for their timely data reporting, without which this report would not have been possible. We are also grateful for the assistance of the IMF's Forecasting and Policy Analysis System (FPAS) mission team for their introduction of the Quarterly Production Model (QPM) as well as the IMF Monetary and Capital Markets (MCM) Division for their valuable comments on the report draft.

## Executive Summary

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The Reserve Bank's inaugural Financial Stability Review assesses the current state, historical trends, and potential future risks facing Tonga's financial system. The key takeaway is that while several financial stability indicators have improved since the dual shocks of the COVID-19 pandemic and the HT-HH volcanic eruption—notably the rebound in private domestic credit growth and inflation falling below the 5 percent reference rate—critical vulnerabilities remain. Chief among them is the sharp deterioration in the Non-Performing Loan (NPL) ratio, which exceeded the internal threshold of 10 percent by the end of 2023. A deeper analysis reveals that the rise in the NPL ratio is driven primarily by the business sector, due to the expiration of bank loan moratoriums implemented after the pandemic and volcanic eruption and persistent structural issues affecting large domestic companies.

Despite this deterioration, Tonga's banking sector remains resilient. The Total Capital-to-Risk-Weighted Asset ratio (32 percent) and the Liquid Asset-to-Total Asset ratio (37 percent) both significantly exceed IMF benchmarks, providing a robust buffer against potential financial shocks. Additionally, when adjusted to include write-offs within the last three years, the NPL ratio has become less volatile, with the reported and adjusted figures steadily converging. This indicates improvements in loan portfolio quality, reduced write-offs, and strengthened loan recovery mechanisms within the banking sector.

To address knowledge gaps in movements related to credit growth, NPLs, and other systemic factors, the report recommends the introduction of a six-monthly Banking Credit Survey. This would enable the NRBT to obtain timely qualitative insights to strengthen its assessment and response. The introduction of risk-based supervision tools would also help to identify credit risks and other vulnerabilities in advance.

An industry-level review of corporate debt highlights agriculture as a key sector facing significant bank funding challenges. The primary obstacle stems from restrictive land allocation practices, which:

- Limit farmers' ability to achieve economies of scale.
- Restrict land use as collateral for loans.
- Discourage investment in mechanization.

As a result, agriculture remains unattractive to financial institutions, forcing producers to rely on alternative financing such as grants, remittances, and off-farm employment. The report recommends policymakers:

1. Strengthen landowners' ability to utilise their land as collateral.
2. Improve rights for producers on leased land by promoting formal contracts.
3. Streamline the processes for banks to recover bad debts, reducing credit risk and enhancing sector stability.

Tonga continues to face challenges in meeting the FATF's Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) standards, impacting correspondent banking relationships (CBRs) with foreign institutions, particularly in the U.S. jurisdiction. Low compliance ratings, especially in enforcement, pose risks to financial stability, investor confidence and borrowing costs.

To address these risks, the report recommends:

1. Strengthening compliance and enforcement of AML/CTF regulations.
2. Increasing awareness of AML/CTF requirements among non-bank sectors.
3. Building capacity and fostering collaboration among relevant authorities to enhance regulatory and operational effectiveness.



**Tatafu Moeaki**  
Governor

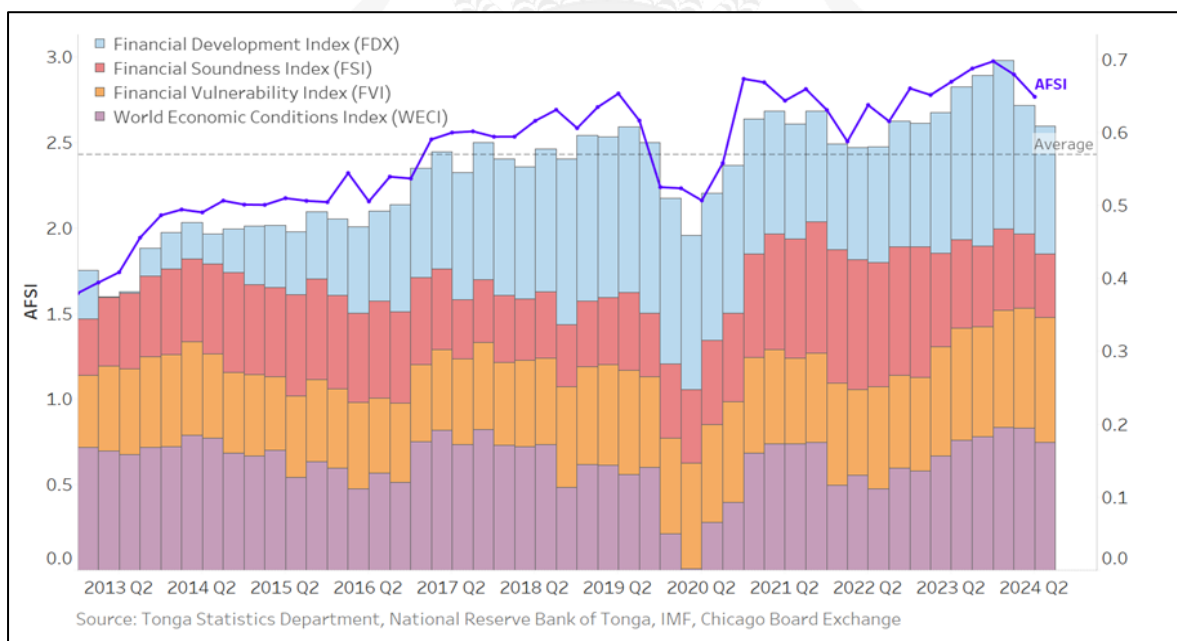
## The State of Financial Stability in Tonga 2024

In order to adequately assess the current state of Tonga’s financial stability, the Reserve Bank has first sought to define it, financial stability refers to

**“The ability of financial systems, comprising institutions, markets, and infrastructure, to fulfil their essential functions. Including, the efficient allocation of financial resources, the provision of credit intermediation & payment services, and facilitating investment opportunities for sustained growth whilst mitigating the impacts of both internal and external shocks.”**

Figure 1 illustrates the Aggregate Financial Stability Index (AFSI) which seeks to provide an overall measure of the current state of Tonga’s financial stability against its historical performance. The AFSI consists of 4 sub-indexes, 3 of which are related to Tonga’s domestic economy, the Financial Development Index (FDX), Financial Soundness Index (FSI), and Financial Vulnerability Index (FVI) with the final relevant to international conditions, the World Economic Conditions Index (WECI).<sup>1</sup> However, it should be noted that each of these sub-indexes are evenly weighted and that an overall improvement in the AFSI does not necessarily indicate an overall improvement in current state of Tonga’s financial stability, but rather provides a gauge for further examination.

**Figure 1: Tonga Aggregate Financial Stability Index (AFSI)**



The latest AFSI (September 2024) recorded a score of 0.65, illustrating an annual decline of 2 index points but remaining above the long-term average of 0.57. Over the year, a significant deterioration in the FSI (14 index points) and a moderate reduction in the FDX (10 index points) outweighed the improvements across the other two indexes.

### Recent Global Economic Developments

**Despite predictions of prolonged stagflation, the global economy is recovering at a better-than-expected pace following the COVID-19 pandemic and the ongoing realignment of the modern geopolitical landscape.**

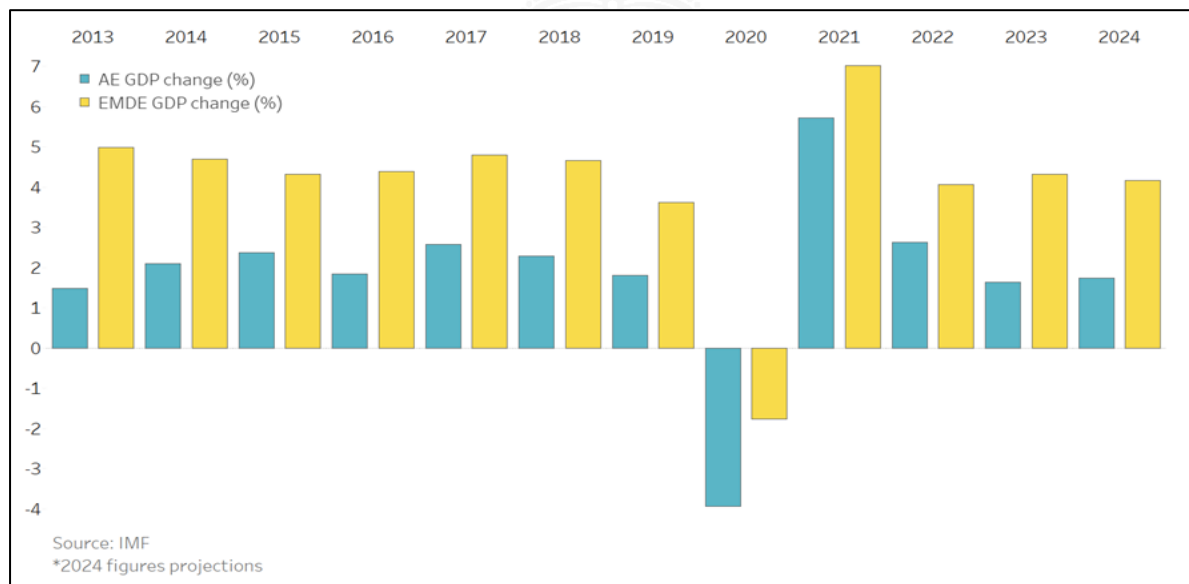
In the wake of increased household consumption post-COVID and supply-chain disruptions triggered by Russia’s invasion of Ukraine in February 2022, the global economy experienced a cost-of-living crisis. Global headline inflation

<sup>1</sup> The sub-indexes are calculated on the weighted approach by multiplying each indicator by pre-determined weights. The value components of each sub-indexes are normalized over the analyzed period (Dec 2012 – Jun 2024). An overall average of all weighted indicators is then computed to determine the AFSI (a score between 0 - 1).

surged to 12.7 percent in Q2 of 2022 and in response, central banks quickly tightened their monetary policies, causing many analysts to predict a long, underwhelming recovery.<sup>2</sup>

Fortunately, major central banks have exceeded their initial expectations. Supply-chain corrections, particularly for fuel and energy, have provided pricing relief in both advanced and developing economies. Global inflation has declined from its peak in mid-2022 to 5 percent for headline inflation and 3.2 percent for core inflation by Q3 of 2023. Most AEs and EMDEs are expected to return to their central bank inflation targets by the end of 2025.

**Figure 2: World Growth - Advanced Economies (AE) vs. Emerging Market & Developing Economies (EMDE)**



However, low-income countries have not experienced the same level of relief, with local prices remaining persistently high. The IMF has revised global GDP growth upward to 3.2 percent for 2024 and 2025 (Figure 2), respectively, with advanced economies, particularly the United States, recovering faster than anticipated despite recent slowdowns.<sup>3</sup>

### Risks to Global Stability

**Although global growth is forecasted at 3.2 percent, and 80 percent of the world’s economies are projected to experience a decline in headline inflation by the end of 2024, substantial downside risks could still hinder the ongoing recovery.**

The first of these is the rising intensity and growing number of geopolitical conflicts. The trend towards an increasingly fragmented world is largely driven by regional players seeking more influence over their geopolitical zones. This is especially true in regions where the United States has shown a declining willingness to directly engage in conflicts, particularly in Europe and the Middle East. An escalation of current conflicts—such as the Russia-Ukraine war or confrontations involving Israel and Iran (and its foreign proxies)—as well as the emergence of new disputes between state and non-state players could disrupt supply lines, hinder global growth potential, and increase uncertainty.

As governments seek to build resilience against these external shocks, many are tightening fiscal policies by reducing government spending or raising taxes to improve their debt-to-GDP ratios. If debt stress leads major economies to accelerate or deepen these cutbacks or tax hikes, the impact on global growth prospects could be significant. Moreover, if core inflation's decline slows, central banks may be hesitant to loosen their contractionary policies and could even increase rates further if inflation targets are not met.

<sup>3</sup> IMF WEO October 2024 Update

For Tonga, the impact of increasing global conflicts will be most apparent in supply line disruptions, particularly for key imports like petroleum and diesel. Fortunately, the Asia-Pacific region remains an area of strategic interest for key nations. The United States, Japan, Australia, and New Zealand are likely to maintain or even increase their engagement in the region, driven by both economic and national security concerns, as well as a desire to counter China's strategic ambitions. Despite Tonga's vulnerability to global price shocks, its location in the Asia-Pacific zone has enabled it to cultivate strong partnerships with these key players. These partnerships, through development projects, expanded economic opportunities, and direct aid or budgetary support, help mitigate Tonga's susceptibility to external shocks.

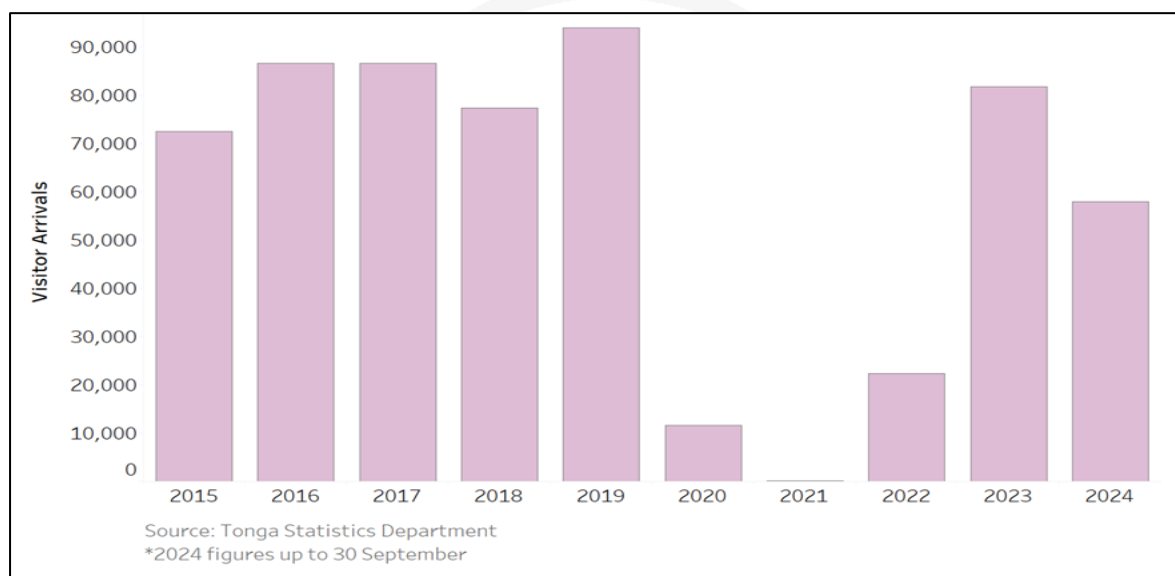


## Domestic Economy Review

While recent recovery efforts have spurred growth and improved tourism numbers, the country faces ongoing challenges such as disaster resilience, reliance on remittances and overseas worker programs, a significant trade deficit, and labour constraints.

The Tongan economy is primarily driven by its staple agriculture, fishing and tourism sectors, all of which are highly susceptible to adverse weather conditions and natural disasters. External shocks, such as the COVID-19 pandemic, severely impacted the tourism industry, with total visitor arrivals plummeting from approximately 94,000 in 2019 to near zero by 2021 (Figure 3). Fortunately, the country's reopening has led to a recovery, with visitor numbers returning to 87% of their pre-pandemic levels.<sup>4</sup> Real GDP declined by 2.3 percent in FY22 but rebounded 2.1 percent in FY23 with the NRBT forecasting growth of 1.6 percent and 2.6 percent for FY24 and FY25, respectively.

**Figure 3: Tonga Visitor Arrivals**



Frequent natural disasters over the past five years, such as Cyclones Gita in 2018 and Harold in 2020, have forced businesses in the tourism sector to allocate significant capital investments towards disaster resilience. The January 2022 tsunami, triggered by the HT-HH volcanic eruption, devastated the west coast of Tongatapu, 'Eua, and Ha'apai, directly affecting 84% of the population and displacing 3,000 people. It also caused extensive damage to crops and destroyed approximately 200 fishing boats, with direct damages estimated at USD 90.4 million.<sup>5</sup> This event was particularly crippling for many Western-facing tourist resorts still recovering from Cyclones Gita and Harold. As a result, there is a growing perception of high risk in the tourism sector, making financing difficult and insurance expensive. This has left the sector largely underdeveloped with government incentives and support from Tonga's development partners necessary to unlock its full potential.

With few value-added exports and an underdeveloped tourism sector, Tonga relies heavily on overseas worker programs such as the PALM and RSE schemes, which provide employment in low to semi-skilled primary industries in Australia and New Zealand. Additionally, remittances from overseas residents account for 38 percent of credits to Tonga's Current Account and 40 percent of GDP (Figure 4), helping to fund the country's large trade deficit.<sup>6</sup> Imports are mainly comprised of retail and wholesale products (60 percent), fuel and oil (17 percent), construction materials (8 percent), and motor vehicles (7 percent). Tonga also faces a significant brain drain issue, as skilled workers, particularly those with tertiary degrees, seek higher wages in advanced economies such as Australia and New Zealand.

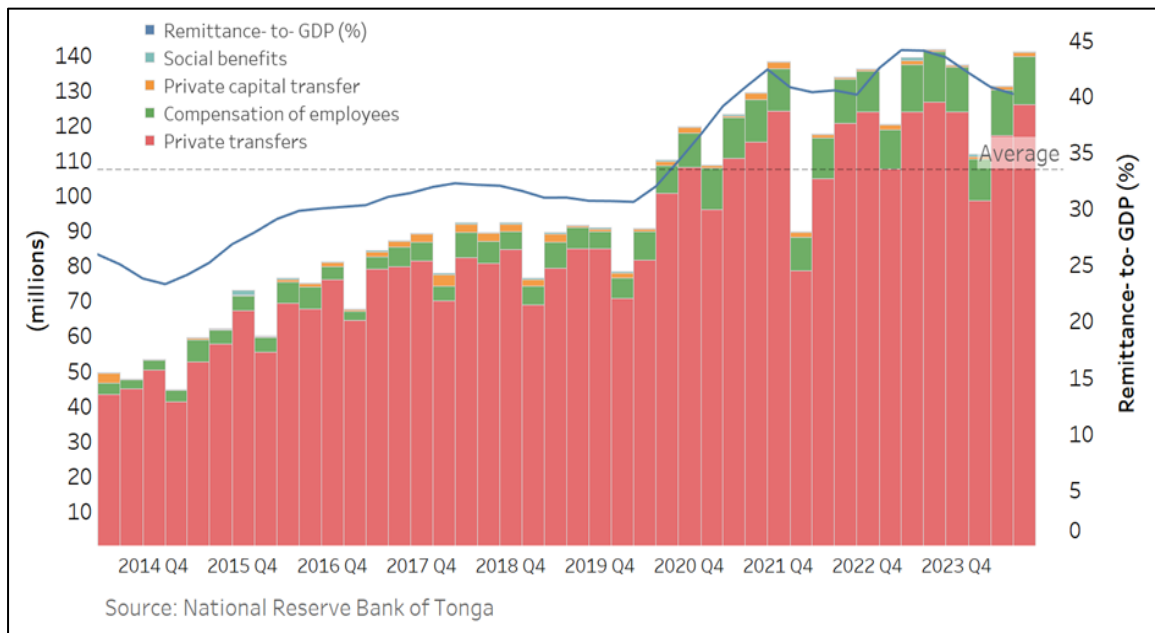
<sup>4</sup> Tonga Department of Statistics – Migration (2024)

<sup>5</sup> IFCR – Tonga, Asia Pacific | Volcano and Tsunami - Revised Emergency Appeal

<sup>6</sup> Tongan Department of Statistics – Balance of Payments

Despite Tonga’s relatively high fertility rate of 3.2<sup>7</sup>, this has contributed to a declining population which has plateaued at approximately 103,000.

**Figure 4: Total Remittance by Receipts**



While consumer confidence and growth have slowed in Australia (1.0 percent annual GDP growth as of June)<sup>8</sup> and New Zealand (0.2 percent annual decline as of June 2024)<sup>9</sup>, potentially reducing demand for Tongan labour, the risk remains low for now. Labour shortages, particularly in primary industries, continue to be a concern for business owners. This is underscored by the ongoing expansion of labour mobility schemes, with the number of Tongan workers deployed in 2024 expected to increase by 40% compared to pre-pandemic levels, which averaged around 5,700 workers per year.<sup>10</sup>

**Table 1: Labour Mobility Schemes**

Number of Seasonal Workers			
	PALM/SWP	RSE	Total
FY2018	2,790	1,899	4,689
FY2019	3,738	2,037	5,775
2020*	746	826	1,572
2021	2,712	255	2,967
2022	927	1,202	2,129
2023	2,517	1,307	3,824
2024**	1,360	850	2,210

<sup>7</sup> World Bank – Fertility rate, total (births per woman)  
<sup>8</sup> Australian Bureau of Statistics – Australian National Accounts  
<sup>9</sup> Stats NZ – New Zealand National Accounts  
<sup>10</sup> Tongan Ministry of Internal Affairs – Labour Mobility Statistics

## Corresponding Banking Relationship (CBR) Withdrawal

Correspondent Banking occurs when one bank (the correspondent) facilitates cross-border payments or other financial services for another bank (the respondent). These services typically include the execution of third-party payments, trade financing, cash clearing, liquidity management, and short-term borrowing<sup>11</sup>.

**Tonga, like much of the Pacific region, has faced increasing challenges in maintaining Correspondent Banking Relationships (CBRs), particularly concerning access to foreign currency accounts.** Over the past four years, two of the four commercial banks in Tonga have had their CBRs with U.S.-based institutions discontinued, preventing them from accessing USD accounts. One of these banks has yet to secure a suitable replacement.

The withdrawal of international services by foreign banks, particularly those under U.S. jurisdiction, has been driven by a combination of low profitability and the perceived risk of reputational damage due to poor Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) compliance in the region.<sup>12</sup> Further details on Tonga’s compliance with AML/CTF standards are covered in the Financial Intelligence section of this report ([Assessment of AML/CFT measures in Tonga](#)).

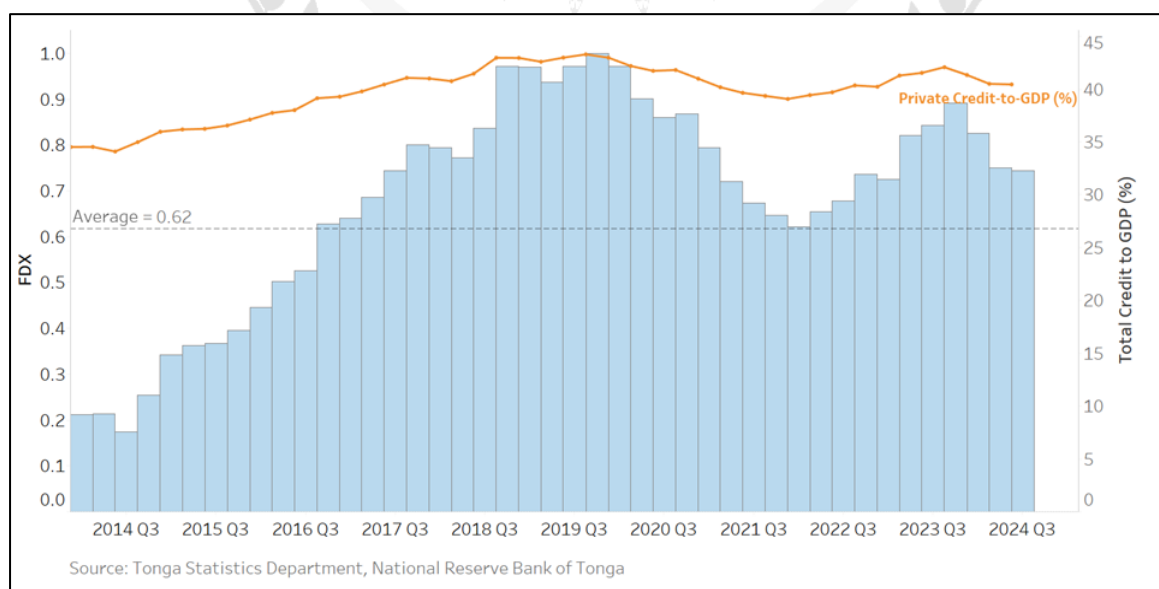
This issue also affects Tonga’s domestic Money Transfer Operators (MTOs), which play a critical role as intermediaries for remittance flows. MTOs, like banks, rely on multiple foreign currency accounts to operate effectively. If this trend continues, it could disrupt the flow of trade and remittance funds into Tonga and reduce market competition, further increasing the already high costs of financial services in a region notorious for expensive banking and transfer fees.

Given the Kingdom’s heavy reliance on overseas remittances, the National Reserve Bank of Tonga (NRBT) has identified this issue as a key challenge to the country’s financial system. To mitigate these risks, the NRBT is working to improve AML/CTF compliance and enhance Tonga’s international reputation. Furthermore, the NRBT is collaborating with key stakeholders, including domestic commercial banks, the World Bank, IMF, and the Governments of Australia and New Zealand, to maintain essential financial services that rely on CBRs. This includes safeguarding the flow of payments and remittances to ensure financial inclusion and stability across the Kingdom.

## Domestic AFSIs

### Financial Development Index (FDX):

**Figure 5: Financial Development Index (FDX)**



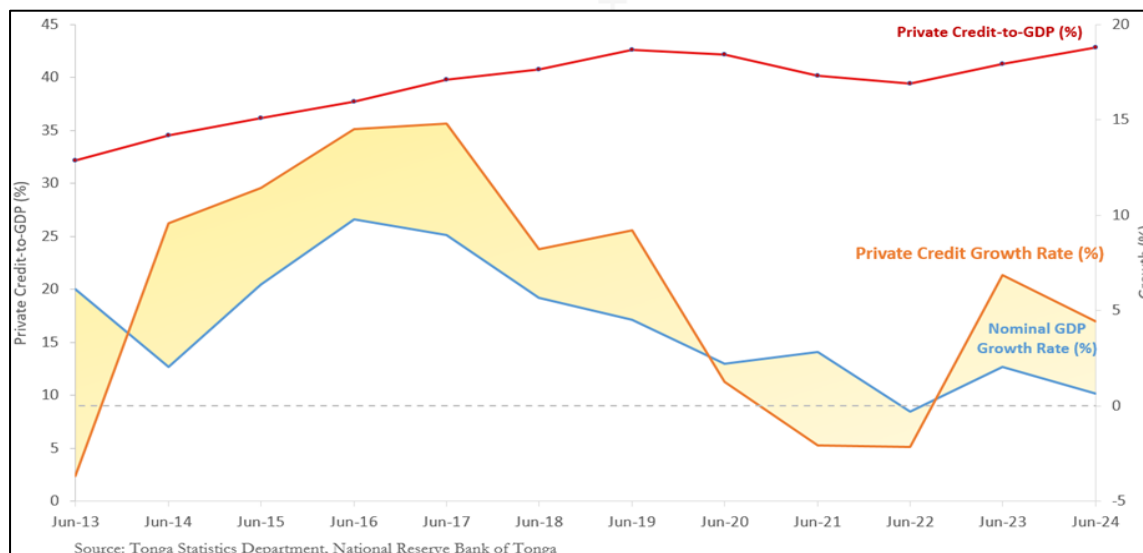
<sup>11</sup> IMF, Report on the Pacific Roundtables - Actions to Address Correspondent Banking and Remittance Pressure (2019)

<sup>12</sup> IMF, Working Paper – Challenges in Correspondent Banking in the Small States of the Pacific (2017)

**Credit Growth is beginning to improve since the pandemic; however, Tonga still lags behind its Pacific peers.** The FDX (Figure 5) consists solely of Tonga’s Total Private Credit-to-GDP ratio as a measure.

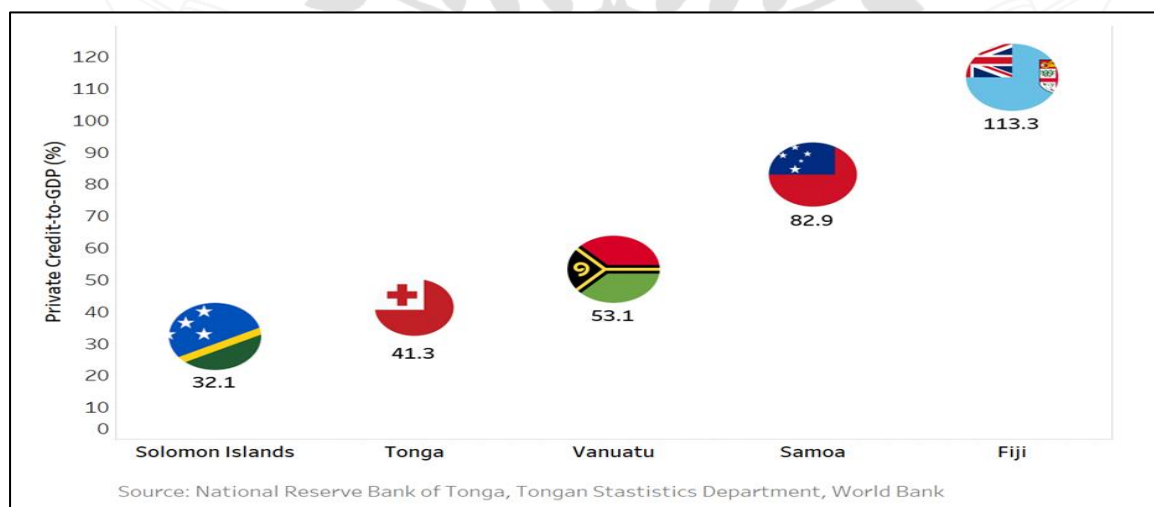
**Error! Not a valid bookmark self-reference.,** on the other hand, illustrates the growth rate difference between Private Credit Growth and GDP to further break down the historical trend of the FDX. Between 2014 until the start of COVID-19 pandemic in 2020, Tonga’s private credit growth outperformed GDP growth. However, whilst GDP was also impacted during the pandemic, the effect on private credit was more severe, taking over 3 years for total private debt to return to its pre-pandemic levels. Since June 2022, private credit growth has outperformed GDP growth indicating a recovery of the sector post crisis.

**Figure 6: Tonga Private Credit-to-GDP (%)**



As the FDX only measures Tonga’s Private Credit-to-GDP against its own historical performance, Figure has also been included to compare Tonga against the other medium income Pacific Island Countries (PIC). As shown, Tonga comes in second last only to the Solomon Islands and quite substantially behind Samoa and Fiji, who record ratios of 83 and 113 percent respectively. Although there are no internationally agreed upon benchmarks for the ratio, as a figure too high could indicate an overheating and/or unsustainable degree of lending in the private sector, given Tonga has fallen behind its peers, it is fair to conclude that Tonga’s private sector is under financed relative to its GDP. The exact reason for this proportionally low level of lending is not fully understood and additional research is required to identify the exact causes. This report, under both the [Household Sector Developments](#) and [Corporate Sector Review](#), will seek to further examine and break down this issue, amongst others, within Tonga’s financial system.

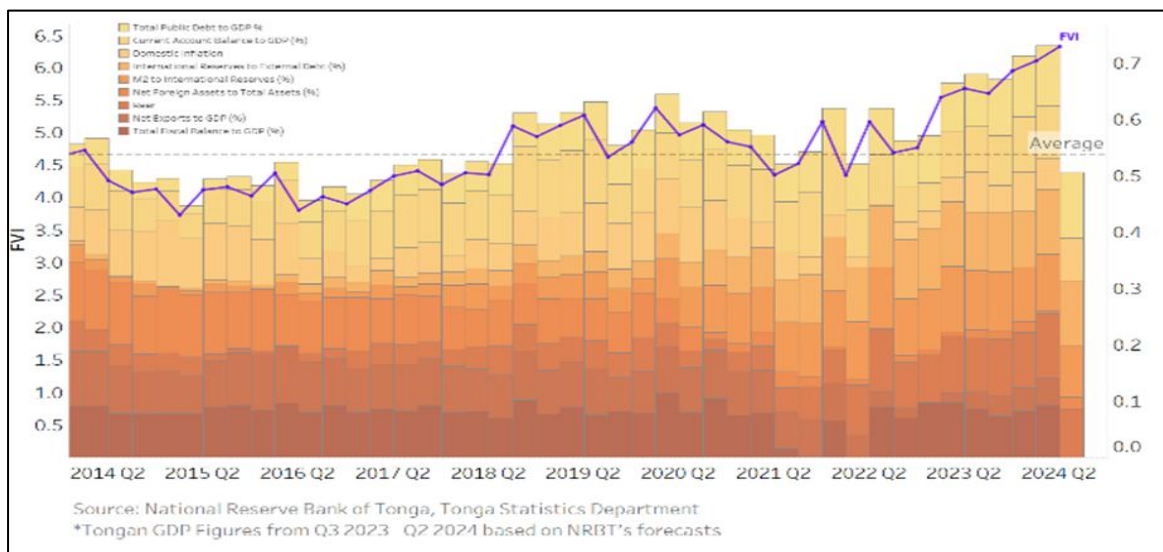
**Figure 7: Pacific Island Countries (PIC) – Private Credit-to-GDP (%) 2023**



### Financial Vulnerability Index (FVI)

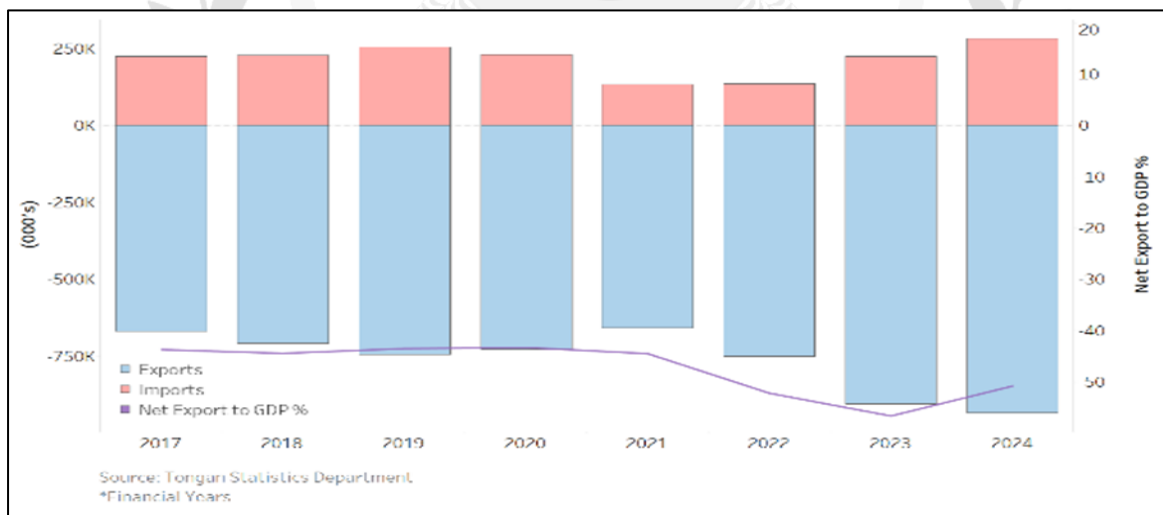
The FVI is made up of nine domestic ratios which signify the overall health of the domestic economy. The most recent complete record (June 2024) puts FVI at 0.70, above the long term average of 0.54.<sup>13</sup>

**Figure 8: Financial Vulnerability Index (FVI)**



**Tonga's Net Export Deficit, at 50.8 percent of output, has decreased over the past financial year (FY2024) as export growth outpaced imports.** This improvement has been primarily driven by a rebound in service exports following the country's post-COVID reopening, which has begun to align Tonga's Net Export-to-GDP ratio with its pre-pandemic levels. Meanwhile, increases in remittances have continued to support import growth, despite sluggish GDP performance.

**Figure 9: Net Exports to GDP (%)**



**Tonga's persistent CAD, largely supported by remittances, decreased in the last financial year to 3.9 percent from 6.8 percent in FY23, lowering the nation's vulnerability to external shocks, exchange rate fluctuations, and imported inflation while highlighting the gains the Kingdom experienced in export growth (predominantly from the service sector).**

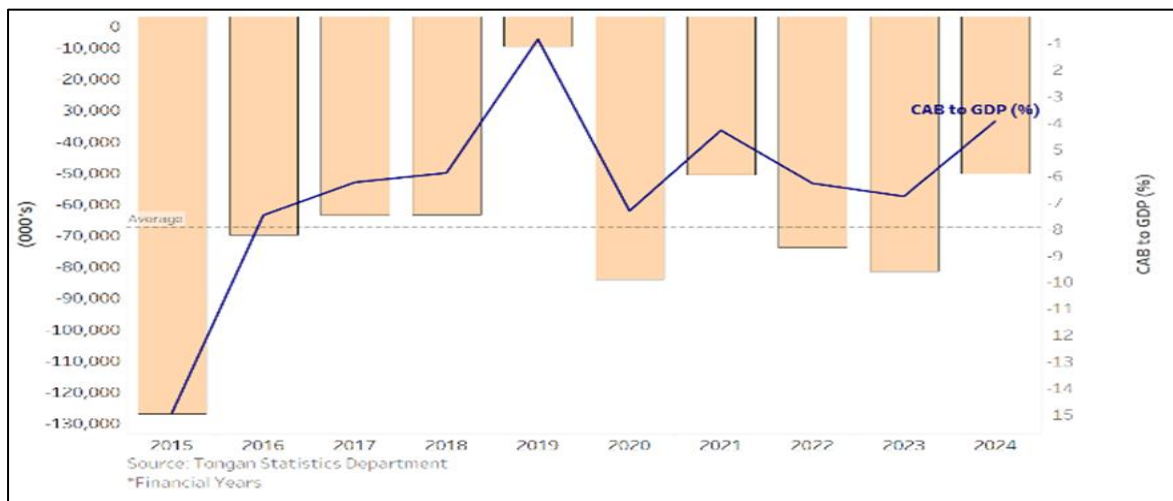
Tonga has run an average annualized CAD of \$67 million since June 2015 (Figure 10). This consistently large CAD has largely been supported by the inflow of remittances from abroad, which have in turn allowed Tongans to purchase

<sup>13</sup> September Index for FVI excludes Current Account Balance to GDP, Net Exports to GDP & Total Public Debt to GDP (%) – No data. Weights have been adjusted accordingly.

a greater amount of imported goods and has played a substantial role in reducing poverty across Tonga over the past 10 years.<sup>14</sup>

A deterioration of the ratio, as what was experienced between FY21 -23, would result in the Tongan economy being more susceptible to exchange rate fluctuations, imported inflation and other external shocks.

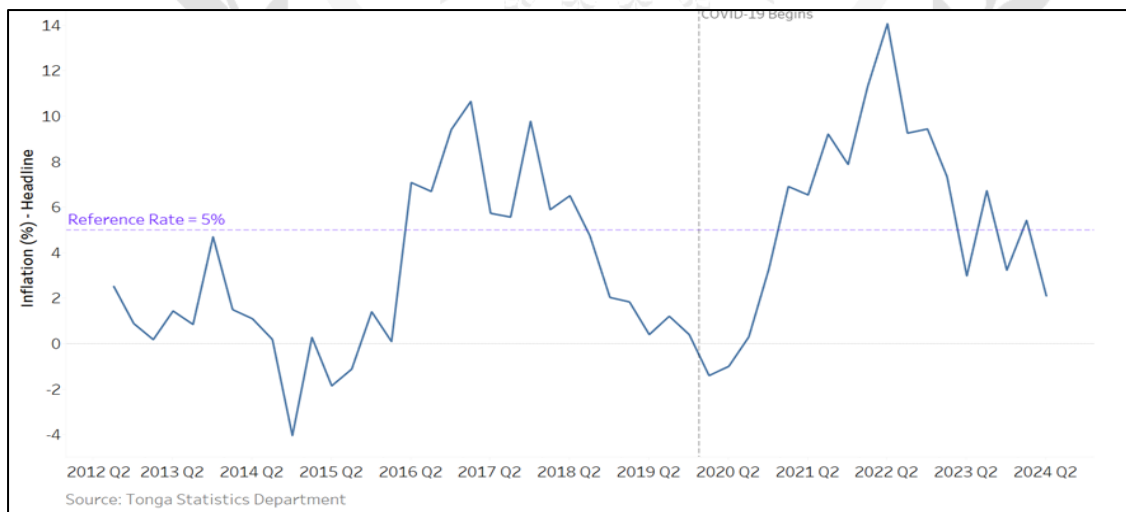
**Figure 10: Current Account Balance to GDP (%)**



The primary concern with a rising CAD outpacing GDP growth is Tonga's increasing reliance on overseas remittances to fund imports and domestic consumption. If these inflows were to slow or cease, the country could face a BOP crisis, as domestically generated income would fall significantly short of meeting current consumption needs. This would lead to a sharp decline in living standards and a rise in poverty.

Additionally, a growing CAD highlights that export growth has lagged behind the surge in imports, indicating a lack of competitiveness in domestic industries. Hence why its recent improvement in the ratio is viewed favorably through the financial stability lens.

**Figure 11: Tonga Inflation (Headline)**



**Tonga's inflation has stabilized below the 5.0 percent reference rate.** As was the case across most global economies, Tonga experienced high levels of inflation as global production attempted to catch up with increased demand for goods and services following the reopening of international borders post-pandemic. Furthermore, supply shocks to global energy following the Russian invasion of Ukraine exacerbated this effect. In response, international

<sup>14</sup> World Bank – Tonga Poverty and Equity Assessment 2024

central banks took measures to tighten their monetary policies to combat these inflationary spikes and have been moderately successful in their endeavors to get inflation under control. As illustrated under Figure 11, since its peak of 14.1 percent in Q3 2022, Tonga’s inflation rate has stabilize closer to the country’s reference rate of 5.0 percent, with the most recent (September 24) figure recording an annual change of 2.1 percent.<sup>15</sup>

However, it should be noted that this improvement of the inflation rate has largely been the result of imported price growth slowly, 0.1 percent annual decrease (September 2024). On the other hand, prices relating to domestic goods & services continues to be at the inflation reference rate, recording 4.9 percent for September.

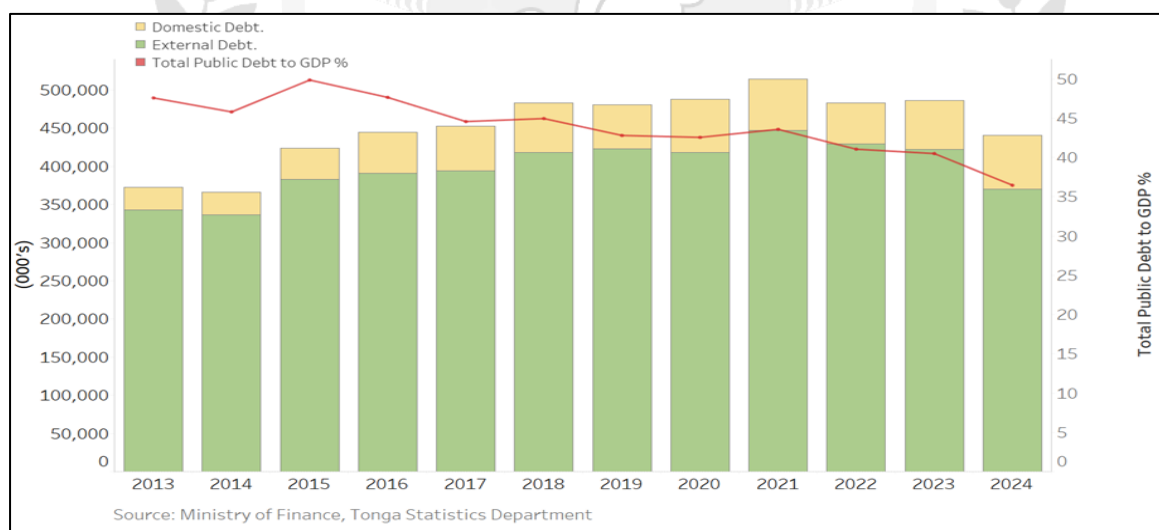
**Tonga’s external debt has been steadily declining as the government aims to reduce foreign exchange risk and shift toward domestic financing, though debt servicing continues to constrain fiscal capacity for essential services and economic recovery efforts.**

As Figure 12 indicates, external debt currently contributes 84 percent of total public debt, however this ratio has steadily been declining over the past decade as the Tongan Government has sought to lower its exposure to foreign currencies. Of the external debt, 47.8 percent is denominated in CNY, 40.7 percent denominated in SDR, with the remaining 11.5 percent made up by a range of other currencies.<sup>16</sup>

Domestic Government debt is fully denominated in Government bonds, however the government is assessing the implementation of other financial instrument options as a means of lowering the percentage ratio of external to domestic debt in order to reduce the foreign exchange risk that may occur due to currency fluctuations.

Since peaking 2021, Total public debt is expected to further decline from its current level \$440.8 million (36 percent of GDP) over the next 5 years, particularly with the repayments of principal (commencing in FY2023) from the significant loan provided by the Chinese EXIM bank.

**Figure 12: Total Public Debt to GDP (%)**

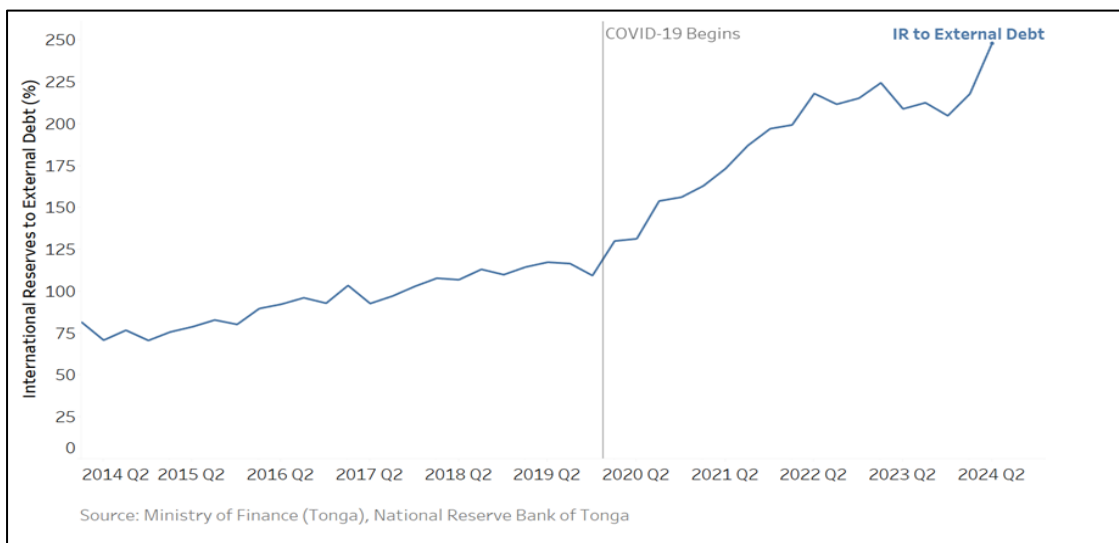


Tonga’s debt burden, as a share of national income (5.65 percent), has consequently impacted the Government’s fiscal ability to stimulate the economy post HT-HH and limits funds for other vital public services such as health and education.

**Currently, international reserves stand at \$905.5 million, composed of 52 percent USD, 20.5 percent NZD, 19 percent AUD, and 7.5 percent SDR.** Since 2017, the ratio has consistently remained above 100 percent, experiencing significant growth following the onset of the COVID-19 pandemic (Figure 13). This rise is attributed to an increase in both remittances and grants from development partners, even as total government external debt peaked. As of June 2024, the ratio is recorded at 218 percent.

<sup>15</sup> Tongan Statistics Department – Consumer Price Index  
<sup>16</sup> Ministry of Finance - Budget Statement – FY2024/25

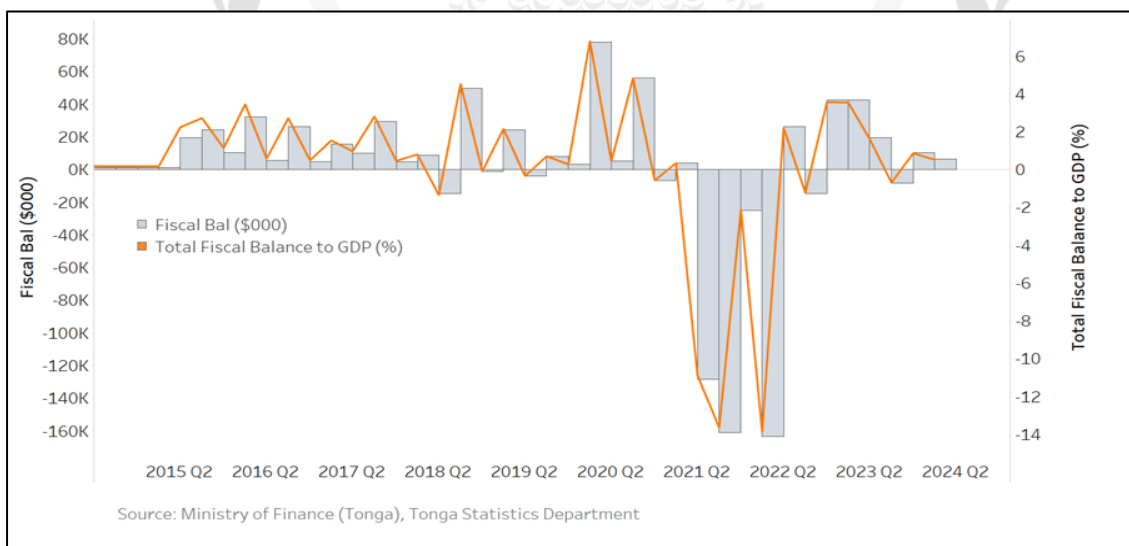
**Figure 13: International Reserves to External Debt (%)**



With the government beginning to consolidate its external debt through repayments on its loan from China’s EXIM Bank, this ratio is expected to continue improving over the coming years. Nevertheless, maintaining close monitoring of international reserves is essential, as any decrease in remittances vulnerability to external economic shocks or market volatility.

**Tonga’s Government is utilising Development Partner funds to accommodate budget shortfalls and debt repayments.** Whereas, Total Public Debt to GDP seeks to capture the stability risk of Government debt over a longer-term period, the Total Fiscal Balance to GDP ratio (Figure 14) presents a measure of health relating to the government’s spending behavior relative to Tonga’s economic output in the short term. The risk of running too many large budget deficits is the implications it may cause reducing the governments reserve funds or, if the deficit is funded by additional lending, increasing the government’s future debt burden. Although the Government is currently going through a period of external debt consolidation wherein, under usual circumstances, large fiscal surpluses would be required to meet its debt serviceability obligations.

**Figure 14: Total Fiscal Balance to GDP %**



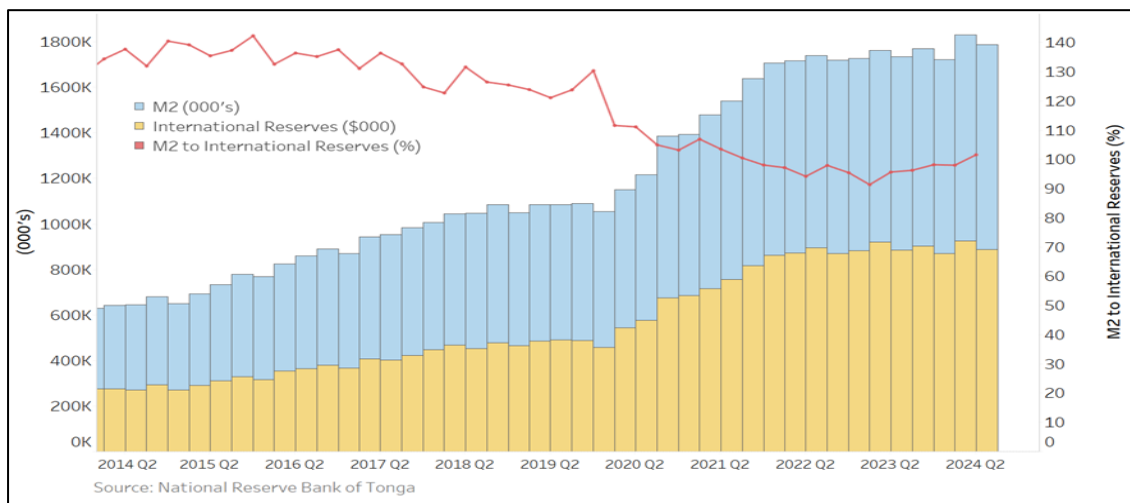
However, the aggregate sum of FY2024’s fiscal surplus (\$28 million), is not adequate enough to meet the Government’s debt obligations of \$68 million in the 2024 financial year, with the shortfall being covered by additional government support from Tonga’s development partners, mainly the Australian Government and the World Bank.

As Figure 15 indicates, the ratio of broad money (M2) to international reserves has steadily improved (decreasing) over the last 10 years as the growth in IR has outpaced the growth of M2.

This ratio, provides a measure of Tonga’s ability to support its domestic money supply with foreign reserves, which is particularly important given it implements a pegged currency basket as part of its monetary policy.

The improvement of this ratio has strengthened Tonga’s position against external shocks and demonstrates that it has sufficient buffer to defend its currency peg. This ratio is also has to be closely monitored over the coming years as large external public debt repayments will ware away at foreign reserves.

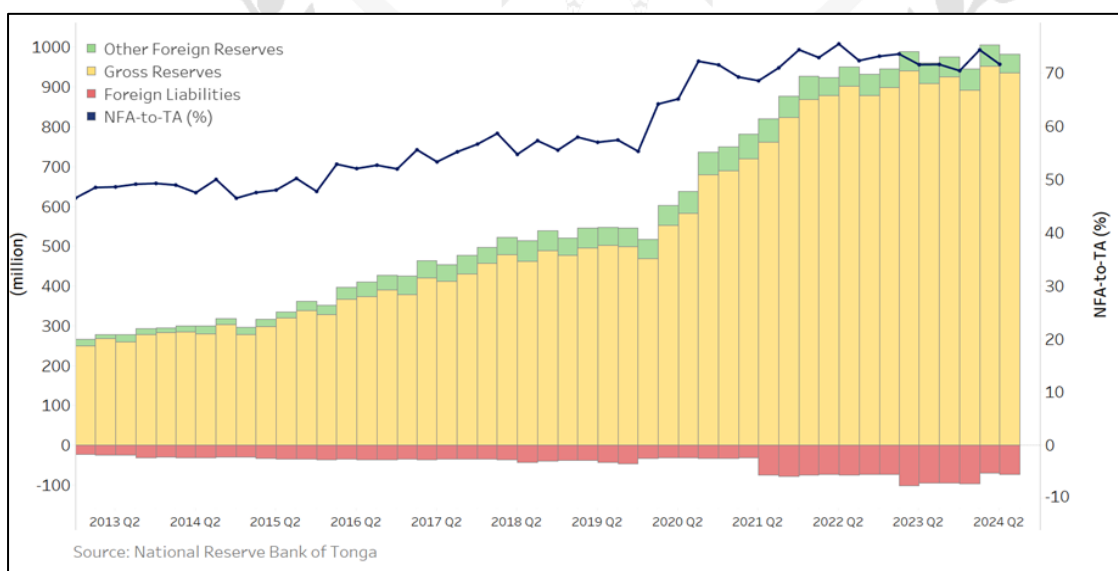
**Figure 15: Broad Money (M2) to International Reserves (IR) (%)**



The NFA-to-TA ratio has steadily increased from 47 percent in 2013 to 72 percent in September 2024, reflecting a growing net creditor position for the reserve bank. While this might suggest increased resilience, it also exposes the NRBT to heightened exchange rate fluctuations and external shocks, as a larger portion of their total assets is now held in foreign currency.

This metric reflects the proportion of the Reserve Bank’s foreign assets relative to their foreign liabilities as a share of total assets. A positive NFA figure indicates that Tongan banks, including the NRBT, hold more foreign currency reserves than external debt.<sup>17</sup>

**Figure 16: Net Foreign Assets to Total Assets (%)**



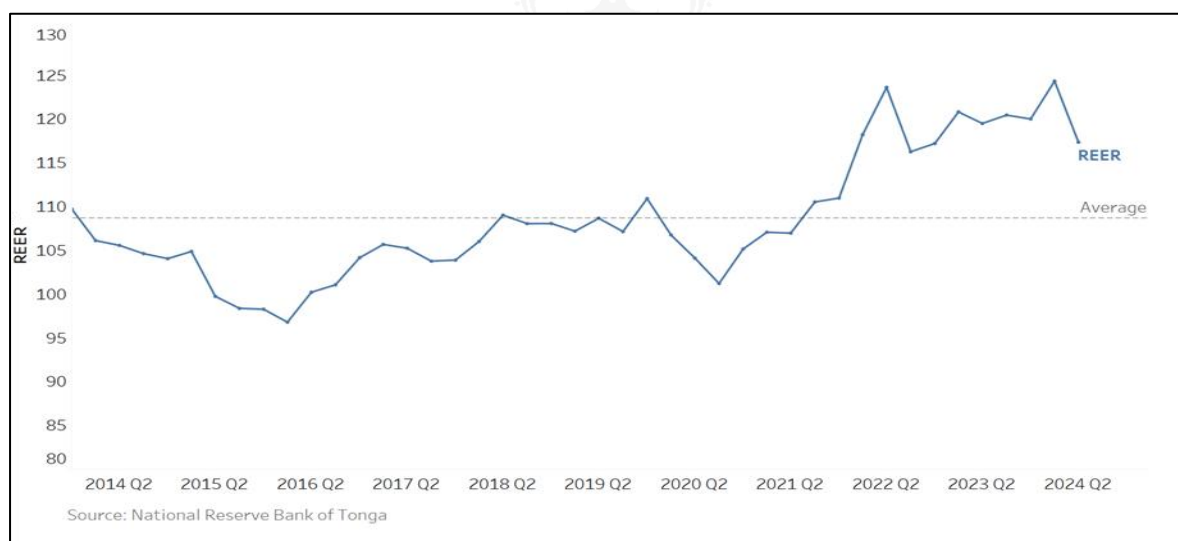
<sup>17</sup> Includes NRBT and commercial bank, however not public FC assets and liabilities.

Figure 16 details the composition of NFA, where gross reserves constitute the majority (90 percent) and comprise foreign currency deposits and securities. The remaining NFA is made up of SDR holdings, reserve positions with the IMF, and accrued interest on foreign-denominated currencies. NRBT liabilities account for 88 percent of total foreign liabilities, with commercial banks contributing the remaining 12 percent.

**Tonga's REER has fluctuated between 97 and 124 since 2013 (Figure 17).** The most recent figure (117) for Tonga sits above the long-term average of 109. The consequences of having a heightened REER is the direct impact it has on deepening Tonga's CAD, as Tonga's domestic goods and services become relatively more expensive compared to its trading partners, weakening the competitiveness of exports and encouraging imports.

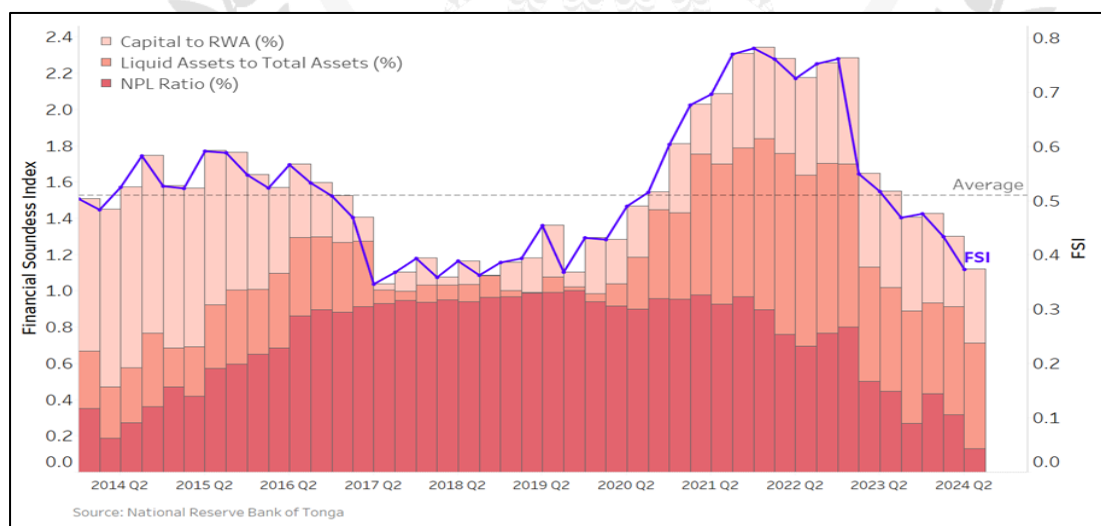
Furthermore, a strong REER also weakens the impact of overseas remittances as the foreign currencies have less purchasing power within Tonga.

**Figure 17: Tonga's Real Effective Exchange Rate (REER)**



### Financial Soundness Index (FSI)

**Figure 18: Financial Soundness Index (FSI)**

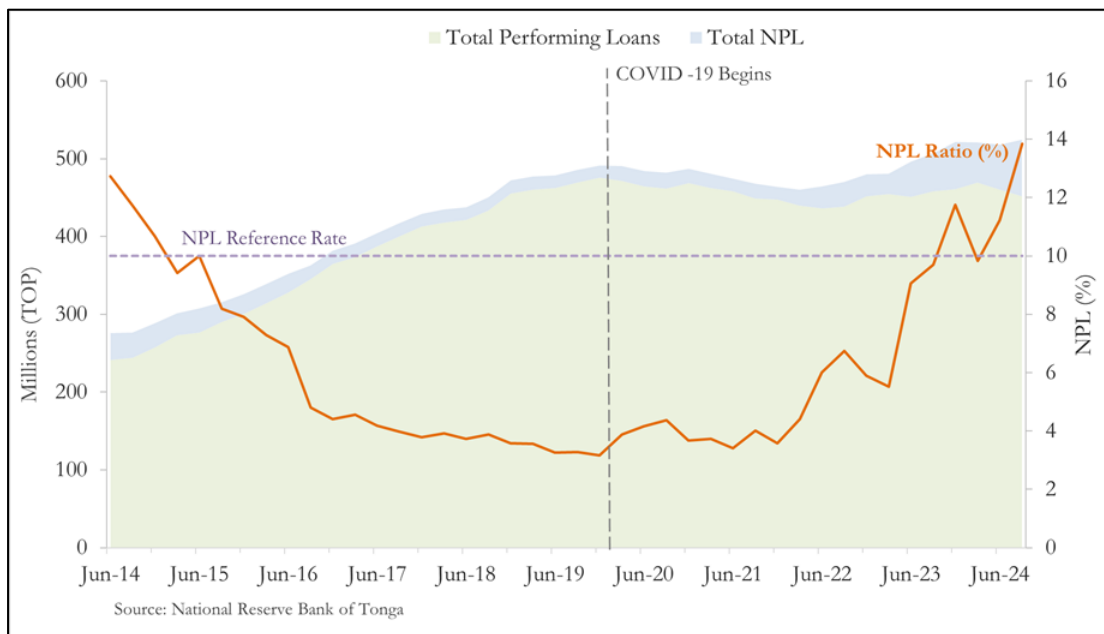


The FSI is composed of three domestic ratios namely Total Capital (TC) to Risk Weighted Assets (RWA), Liquid Assets (LA) to Total Assets (TA), and non-performing loans (NPL) ratio. The FSI examines the overall health of the domestic financial system. It is currently the most poignant index as it has steadily been deteriorating since the start of 2023 and currently sits at 0.37 as of September 2024, below the long-term average of 0.51. Although Tonga's FSI has been slowly declining since March 2023, the TA-to-RWA ratio remains above the minimum requirement of 15.0

percent indicating that the banking system remains well capitalized to withstand unexpected shocks in the system. However, the risks of rising NPL remains a concern and requires prudent supervision and monitoring.

By the end of September 2024, the bank’s total NPL ratio reached 13.4 percent, an increase of 3.7 percent from September 2023 and 9 percent from March of 2020, remaining above Tonga’s internal trigger level of 10 percent. NPL levels have risen steadily since the COVID-19 lockdown in 2020, reflecting the economic hardships faced by both businesses and households.

**Figure 19: Non-Performing Loans**



The majority of NPLs originate from businesses, accounting for approximately 78 percent, with the remainder from individual household loans. Although loan moratoriums provided temporary relief during the pandemic, the compounded negative impacts of COVID-19 and the HT–HH volcanic eruption have exacerbated these challenges, as reflected in the latest National Accounts Report for FY2023.

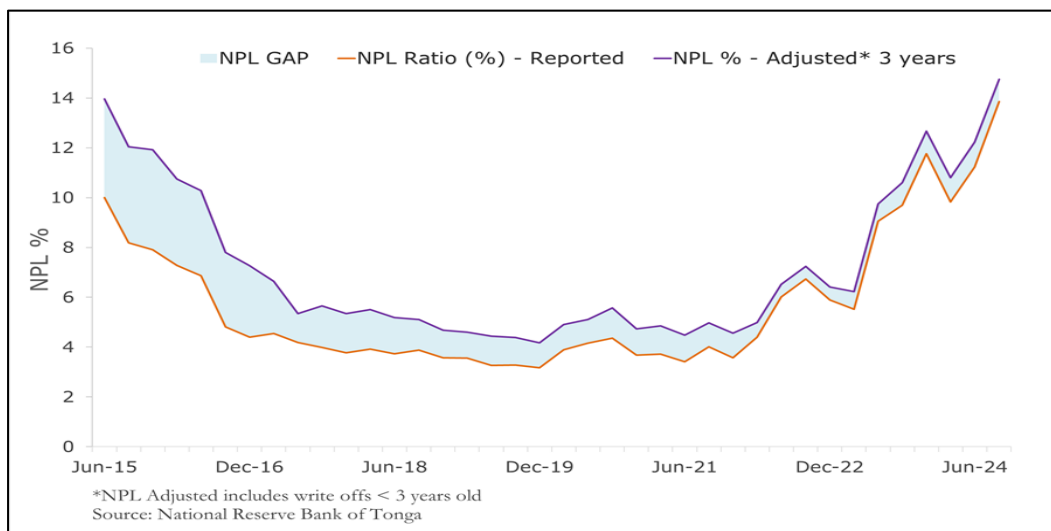
Since elevated NPLs negatively affect banks’ asset quality, it is essential for banks to enhance their due diligence in credit provisions, aiming to manage credit risks effectively while preserving investor confidence and profitability. Ongoing global economic uncertainties and the impacts of natural disasters present further risks that could strain businesses and individuals’ capacity to service loans. Further analysis of the bank’s NPL will be detailed in the [Household Sector Developments](#) and [Corporate Sector Developments](#) sections.

Over the past decade, fewer bank write-offs have led to the Adjusted and Reported Non-Performing Loan (NPL) ratios trending toward convergence, with the Adjusted NPL sitting 0.9 percentage points higher than the Reported NPL as of September 2024. Since write-offs are excluded from the standard NPL ratio, the banking sector’s solvency performance may be understated. For instance, an improving NPL ratio could simply reflect one or more banks recognizing a write-off expense in their profit and loss statement while removing the liability from their balance sheet. To address this, it is prudent to examine the Adjusted NPL ratio, which accounts for these exclusions.

However, including write-offs indefinitely can distort NPL trends, particularly in banking sectors with a history of significant bad debts. To mitigate this, our calculation incorporates write-offs from only the past three years.

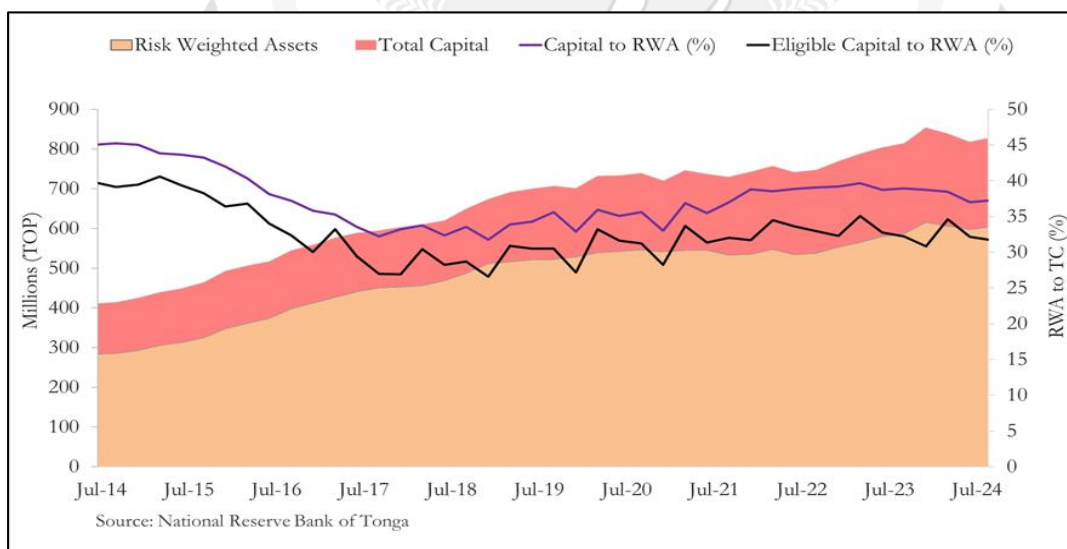
Figure 20 illustrates the gap between the Adjusted and Reported NPL ratios. In June 2015, significant write-offs totaling \$15.95 million over the prior three years resulted in the Adjusted NPL ratio reaching 14.0 percent— 4 percent more than the Reported ratio of 10 percent. In the nine years since, fewer write-offs have been recorded, causing the two ratios to gradually converge— reaching a low point of 0.5 percent in June 2022. The gap has slightly widened since, hitting 0.9 percent by September 2024, with cumulative write-offs over the preceding three years declining to \$6 million—62 percent lower than in June 2015. This trend suggests an overall strengthening in the banking sector’s aggregate risk portfolio as well as its management and recovery mechanisms.

**Figure 20: NPL Ratio - Reported vs. Adjusted**



As of September 2024, the ratio of TC-to-RWA was 37.3 percent, slightly below the long-term average of 38 percent. This marks a decline of 1.7 percentage points compared to September 2023, driven by a 1.5 percent decrease in total capital and a 3.1 percent increase in RWA.

**Figure 21: Capital to Risk Weighted Assets**



Despite this, the ratio of eligible capital<sup>18</sup> to RWA remains well above the IMF-recommended threshold of 15 percent, standing at 31.7 percent in September 2024, down slightly from 32.2 percent in September 2023. Total eligible capital improved by 1.3 percent year-over-year, primarily due to a 19.3 percent rise in retained earnings. This indicates that the banking system maintains a strong capital base relative to its risk exposure, providing a solid buffer against potential losses and unexpected shocks.

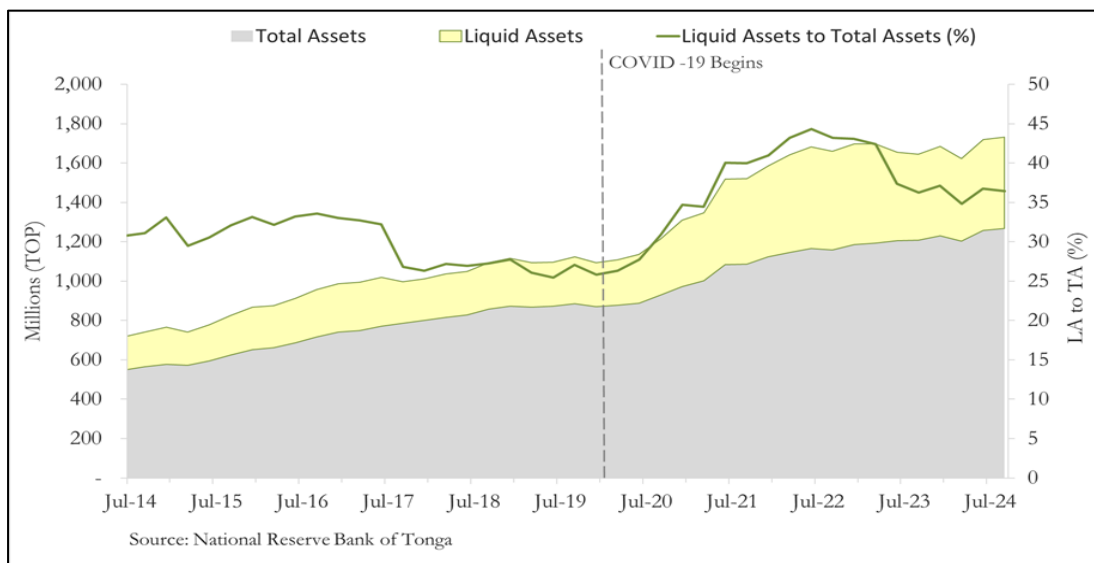
However, the growth in RWA, particularly due to a 3.1 percent annual increase in loans and advances, highlights the need for careful monitoring. To preserve a strong capital position amid potential shocks, banks should continue to enhance retained earnings, through their strong profitability position, while actively managing loans and advance risks.

**The bank's overall LA increased by 5.6 percent year-over-year to September 2024, bringing the LA-to-TA ratio to 36.4 percent.** LA peaked at \$516.1 million in Q2 of 2022, due to a high influx of donor funds and remittance receipts following the HT-HH volcanic eruption, which bolstered banks' cash balances. Consequently, the LA-to-TA

<sup>18</sup> Tier 1 capital less intangible assets

rapidly increased from 28 percent in June 2020, reaching a peak of 44.3 in June 2022, before declining to 36.4 by the end of September 2024—still above the long-term average of 33 percent.

**Figure 22: Liquid Assets to Total Assets**

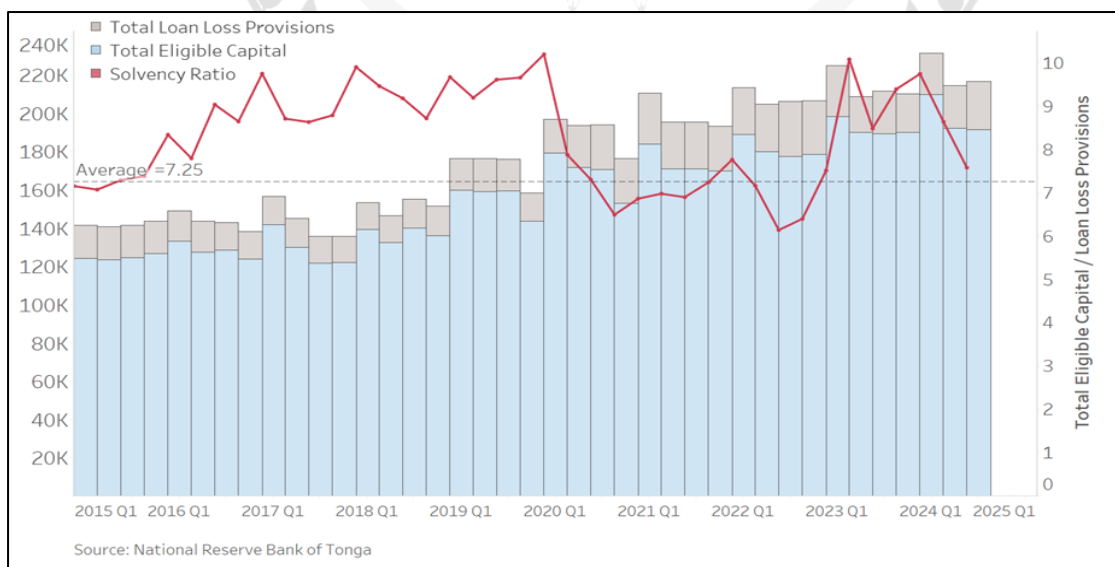


The liquidity drop from June 2022 onwards largely reflects a rapid decline in one bank’s performance, which in turn led to its placement under strict NRBT supervision.

Despite this, the banking system’s liquid asset-to- liabilities ratio (LAR) remains robust, standing at 46.8 percent as of September 2024, well above the 5 percent minimum requirement as well as the IMF’s recommended range of 20 – 30 percent. Although deposits comprise a significant portion of bank liabilities—which can strain the LAR—the required reserves held at the central bank make up a large share of their liquid assets. This reserve requirement, which grows with deposits, serves as a safeguard against unexpected shocks or liquidity shortfalls.

While the banking system's liquidity position remains sound, prudent management of individual banks' liquidity is crucial. Adherence to central bank supervision and policy directives is essential for maintaining a stable and resilient financial system.

**Figure 23: Solvency Ratio - Eligible Capital to Loan Loss Provisions**



**Over the last 6 months of reporting, both EC has decreased whilst LLP have increased, causing the Solvency ratio to dip to 7.5 (September 2024).** As Probability of Default (PD) and Loss Given Default (LGD) are absent measures in Tonga the NRBT utilises the Eligible Capital (EC) to Loan Loss Provisions (LLP) as a proxy in its place.

Wherein EC is the banking system's buffer against expected and unexpected losses and LLP captures the scale of potential loan losses that threaten solvency within the system.

As indicated in Figure 23, Tongan banks had steadily been increasing their EC from 2015 up to the start of the pandemic (Q1 2020) as a result of an increase in retained earnings (\$3.8 million increase in net profit after tax (between 2015 – 2020). Furthermore, an improvement in the risk portfolio also meant smaller special provisions needed to be set aside. As a result, the Solvency ratio improved to a peak of 10.2 by December 2019, implying the banks' buffer could cover their general and special provisions 10 times over if required.

At the start of the pandemic, the Solvency Ratio sharply decreased as uncertainty for many Tongan households and businesses increased the need for provisions, reaching a low point of 6.1 in September 2022. Following this, the ratio then began to improve returning to near its pre-COVID levels in June 2023.



## Household Sector Developments

Total household sector debt as of 30 September 2024 stood at \$270 million, with an annual growth rate of 5.1 percent, compared to 1.6 percent over the same period the previous year—below the long-term trend of 7.1 percent. Household borrowing comprised 55.4 percent of the banking industry’s total loans, with lending concentrated primarily in the housing sector (Error! Not a valid bookmark self-reference.).

**Figure 2: Total Household Debt**

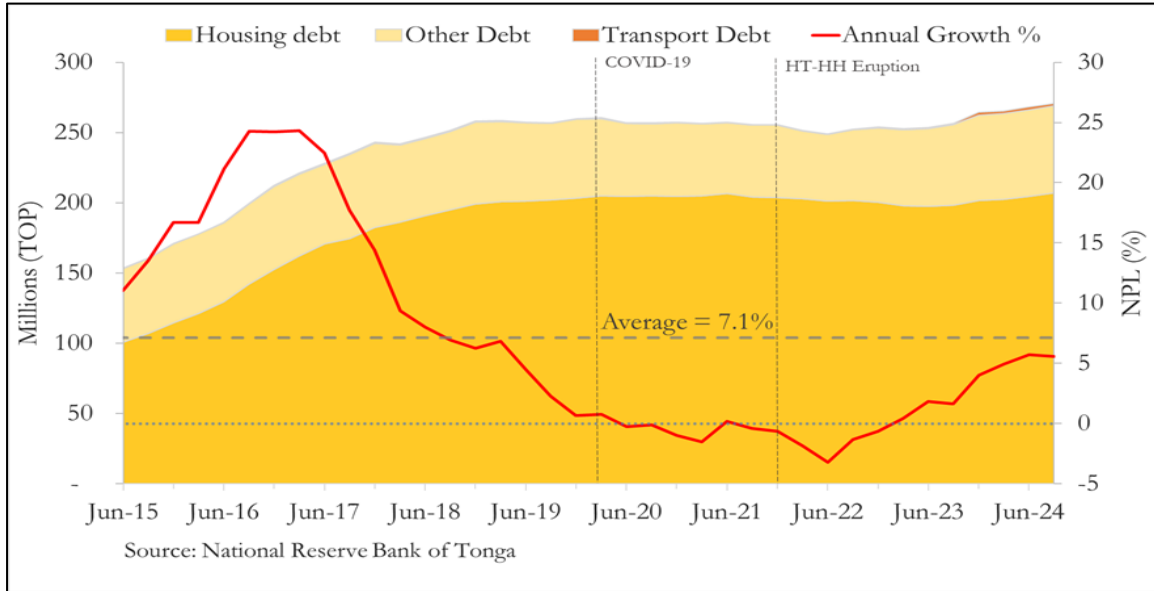
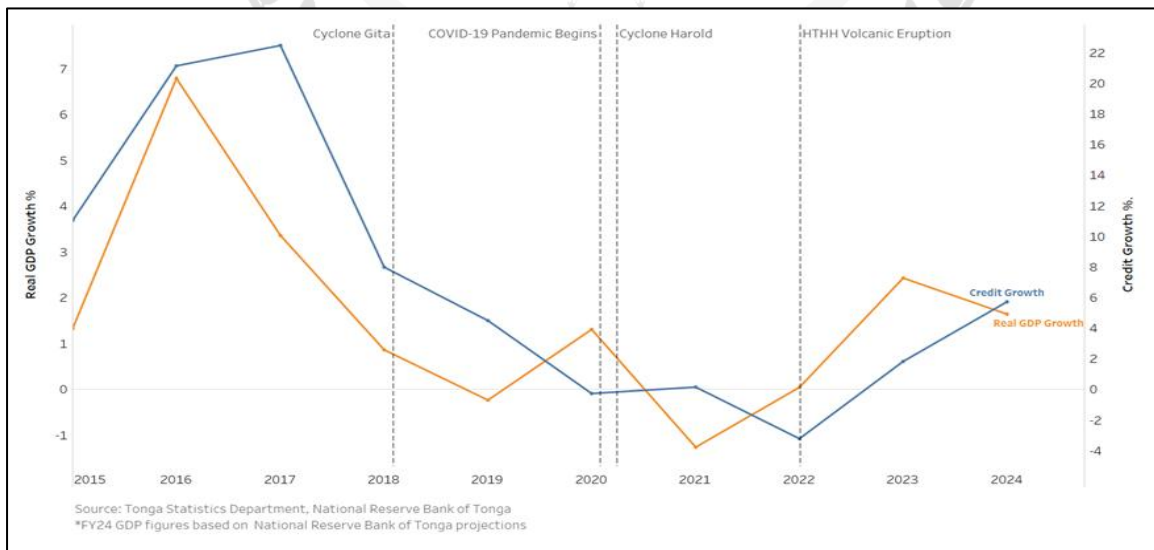


Figure 25 illustrates a strong positive correlation between annual household credit growth and real GDP growth, indicating that household credit growth is significantly influenced by both internal shocks, such as natural disasters, and external events impacting GDP, such as the COVID-19 pandemic. Credit expansion, which surged from 2014 to 2017, began to slow and eventually regressed during the pandemic. This stagnation persisted for approximately three years, with total household debt only surpassing pre-pandemic levels by December 2023.

**Figure 25: Real GDP Growth vs. HH Credit Growth (%)**



To assess whether household sector debt levels are excessive, the Household Credit to Household-Disposable-Income ratio (credit gap) is used.<sup>19</sup> As of 30 September 2024, households reported four periods of a positive credit gap, with the latest being 1.3 percent (Figure 26). Prior to this, Tongan households experienced a negative credit gap lasting 14 quarters post-pandemic. This trend suggests that household credit growth recovery is now on track after the pandemic’s prolonged impact.

**Figure 26: Credit to Household Disposable Income (%)**

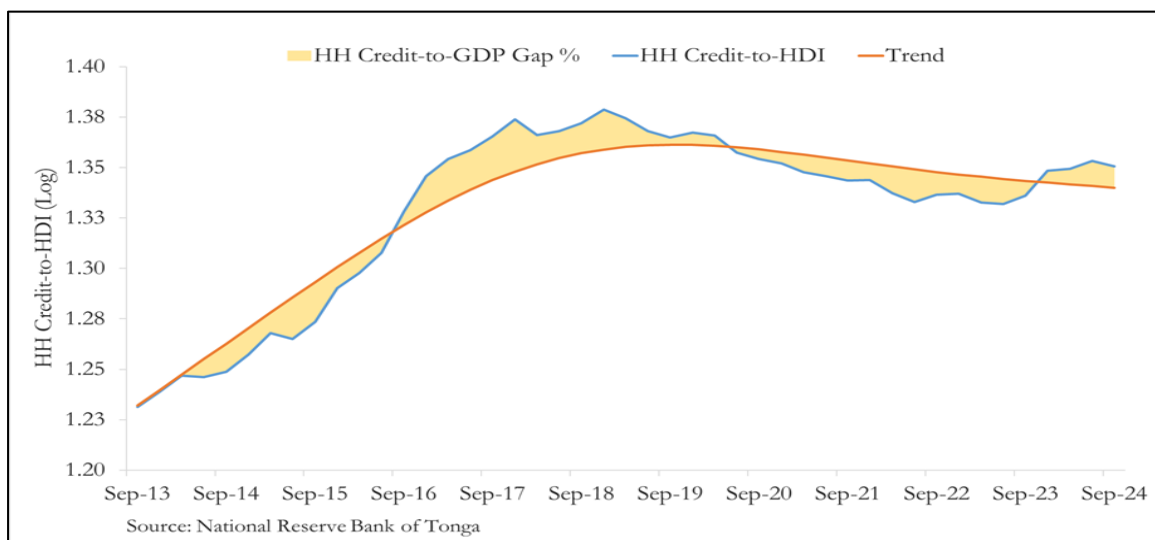
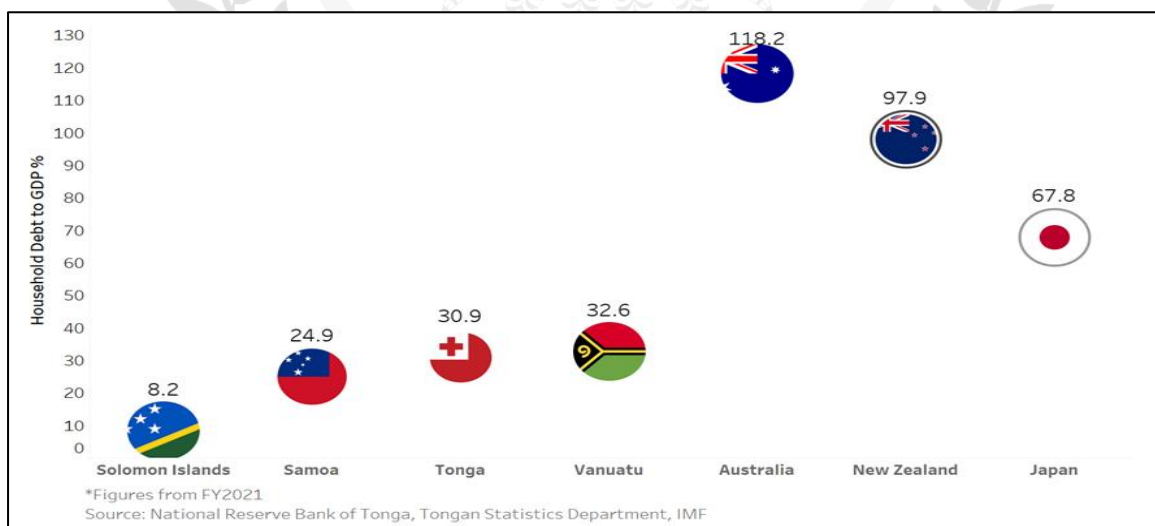


Figure 27 compares Tonga’s household debt-to-GDP ratio against its Pacific region peers. Tonga’s ratio of 30.9 percent aligns with other medium-income Pacific Island nations but is notably lower than that of developed countries in the region (e.g., Australia, Japan, and New Zealand). This disparity can be attributed to factors common in developing economies: fewer lending institutions, lower income levels, limited debt serviceability, and higher interest rates.

**Figure 27: Household Debt to GDP % (Pacific Island Nations)**



However, there are factors unique to Tonga and the broader Pacific region that affect private credit growth. First, land allocation processes constrain credit access: all land in Tonga is owned by the Crown, with male Tongans entitled to receive agricultural (Tax) and town allotments.<sup>20</sup> Under the Land Act, individuals do have the right to formalise a

<sup>19</sup> Household Disposable Income (HDI) = 93.3% (private Consumption) + 5% (household savings rate) of GDP

<sup>20</sup> Tonga Land Act – Revised Edition 2016

lease agreement through the Ministry of Lands and banks are willing to accept these formally registered lease agreements as collateral. However, the length of the loan cannot be longer than the formal lease agreement, which is also subject to the maximum period specified in Act, with all formal leases subject to ministerial approval. Additionally, incomplete or imprecise land records make land-based transactions time-consuming and costly.

Secondly, elevated costs of doing business and weak entrepreneurial capacity has lead Tongans to rely substantially on remittances from the Tongan diaspora, along with short-term labor mobility programs, frequently substitute for bank funding sources. Furthermore, Members Savings Clubs<sup>21</sup> as well as public servants accessing loans from their public retirement fund (RFB) also act as alternatives to banks for Tongan’s personal funding requirements.

**Table 2: Credit Source - Tongan Households**

Credit Source	% of Respondents
Shop credit	23
Bank	9
MFI	5
Family	5
Savings Club	5
Pawnbroker	3
Employer	3
Moneylender	2
Cooperatives	1
Hire Purchase	1

Source: National Reserve Bank of Tonga, Pacific Financial Inclusion Programme

Finally, for cultural reasons, Tongans tend to be less forward looking with their finances, typically living month-to-month and relying heavily on friends, family and the wider social fabric for their financial needs. A Financial Demand Side Survey conducted in Tonga in 2016 found that only 37 percent of Tongans had been engaged in credit activities within the last year, with shop credit being by far the most utilised (23 percent) - \$50 being median amount borrowed, with only 9 percent of respondents indicating that they had borrowed from a bank.<sup>22</sup> Micro-Financial-Institutions (MFI) and family each accounted for 5 percent of respondents and despite the high number of money lenders registered within Tonga (103), only 2 percent of those surveyed indicated that they had utilised them over the past 12 months. Moreover, the communal structure of Tongan society - with expenditures dedicated to family events and church obligations - limits household capacity for savings, thereby impeding their ability to accumulate the up-front deposits required for larger loans.

### Household Non-Performing Loans

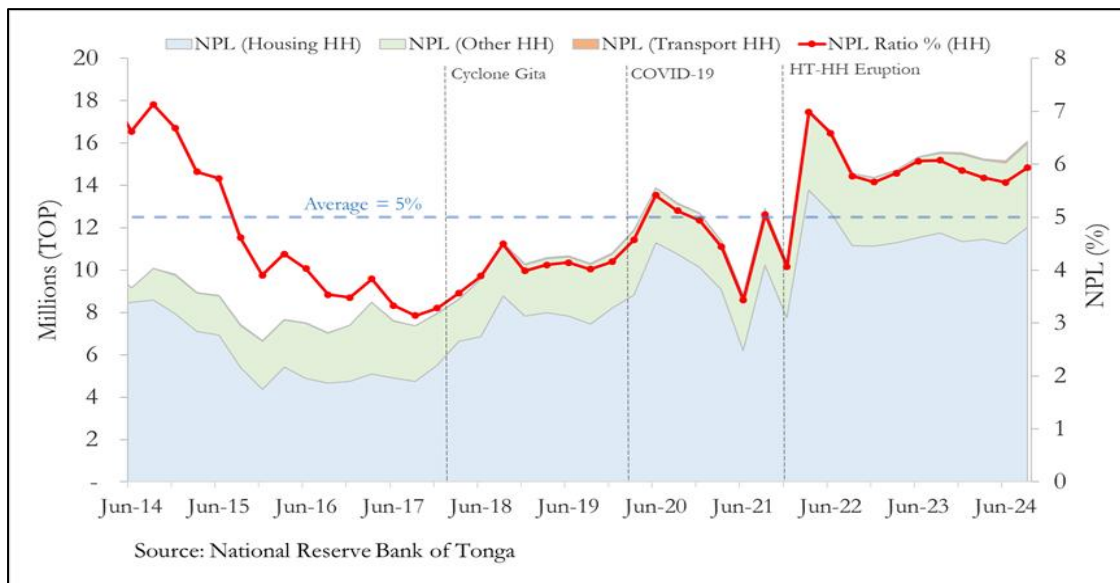
**In line with the economic recovery, the household sector’s NPLs ratio has marginally improved in the year** leading to September 2024, registering at 5.8 percent compared to 6.1 percent for the same period the following year, and continued to be dominated by housing loans, followed by personal and transport (be-it immaterial) loans, respectively. **Error! Not a valid bookmark self-reference.** also displays the close relation HH NPL has with output, the strong real GDP growth experienced between 2013 – 2017 (3.3 percent average) correlates with a sharp decrease in the HH NPL ratio from 7.4 to 3.3 percent. Similarly, the three natural disasters (Gita, Harold, and the HT-HH volcanic eruption), and their adverse effect on output, negatively impacted the HH NPL ratio from its low point in September 2017. It should also be noted that the commercial banks, following COVID-19 and cyclone Harold,

<sup>21</sup> Informal social financing utilising handicrafts as collateral.

<sup>22</sup> National Reserve Bank of Tonga in collaboration with Pacific Island Inclusion Programme - Financial Demand Side Survey Tonga 2017

introduced loan moratoriums to households on a case-by-case basis leading to the restructuring and redefinition of certain HH loans that would otherwise be considered non-performing. As a result, the HH NPL ratio is understated between 2020 and 2022 with the majority of moratoriums to households having now expired.

**Figure 28: Household Non-Performing Loans to Total Loans (NPL %)**



### Future Household Credit Developments & Policy Recommendations

As explored in this section, HH credit growth and its corresponding NPL ratio is strongly correlated to GDP growth and is therefore highly susceptible to adverse natural disasters and other internal and external shocks. Relative to its output, household credit is generally in line with its closely related peers. However, given other indicators appear to be favourable to the current domestically operating banking institutions including moderately strong returns on both assets (2.0 percent) and equity (10.4 percent)<sup>23</sup> as well as significant interest rate spread (6.3 percent), it is not quite clear why the household credit rate isn't higher.

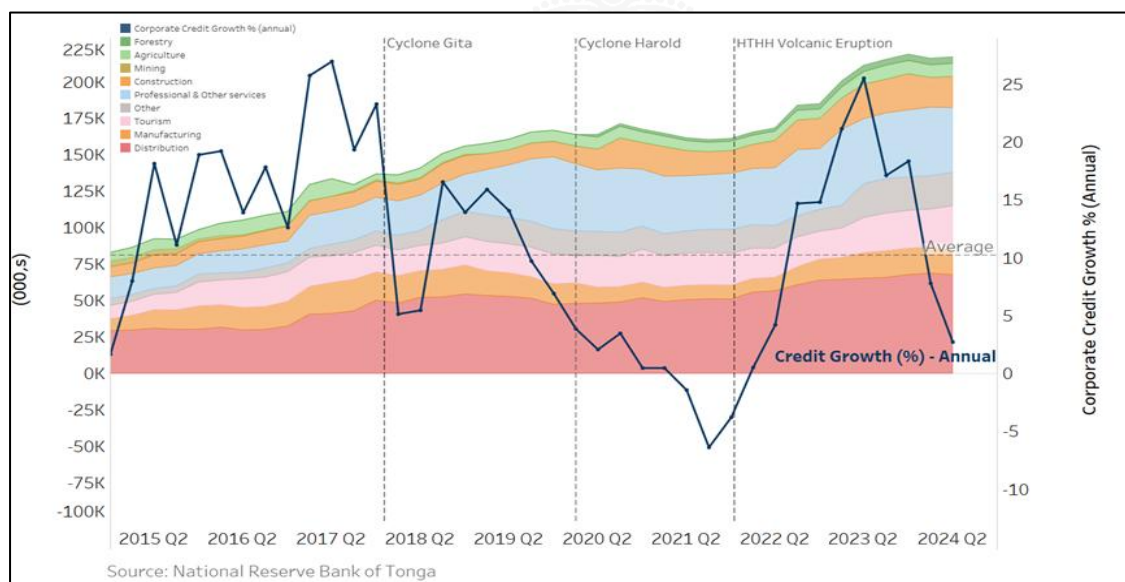
Although we have examined some of the potential reasons in this section, further research needs to be conducted in order to draw adequate conclusions to our hypothesis. The implementation of NRBT's new bi-annual Banking Credit Survey should help provide some qualitative data on and reasoning behind the movements in both HH credit growth and the corresponding NPL ratio as well as identify what factors are obstructing the commercial banks from providing more credit to Tongan households. Furthermore, the NRBT is also seeking to assist in the establishment of a National Credit Registry aimed at reducing the time and cost banks incur during the approval and on-boarding period as well promoting borrower access to disaster insurance for housing assets to help mitigate the environmental related risks. Furthermore, it has adopted risk based supervision tools in order to try and identify credit risks and vulnerabilities in advance.

<sup>23</sup> June – annualised after tax figures

## Corporate Sector Developments

Aggregate corporate credit stood at \$217 million as at 30 September 2024, registering an annual growth of 2.7 percent compared to 2.5 percent for the year prior (Figure 29). The strong credit growth (18.6 percent – annual) experienced between Q4 2022 – Q1 2024 was largely due to initiatives from government funneled predominantly into construction projects post HT-HH as well as for developments in preparation for the PIF which was hosted in Tonga August 2024. As a result total construction debt rose by 51 percent over this period.

**Figure 29: Corporate Credit Concentration vs. Credit Growth (%)**



As at 30 September 2024, business loans continued to be concentrated in the distribution (31 percent), professional & other services (20 percent), and tourism (14 percent).

**Figure 30: Corporate Credit-to-GDP Gap (%)**

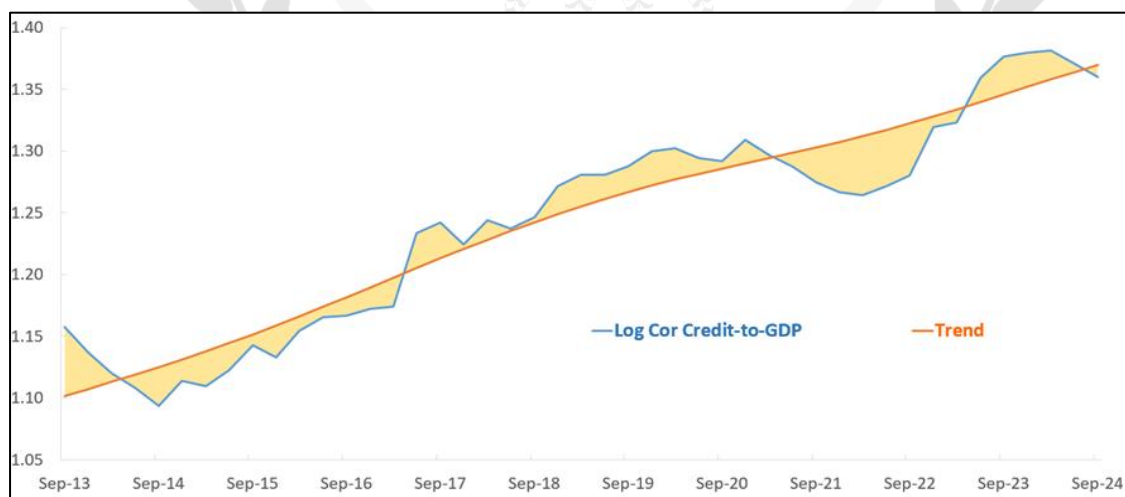


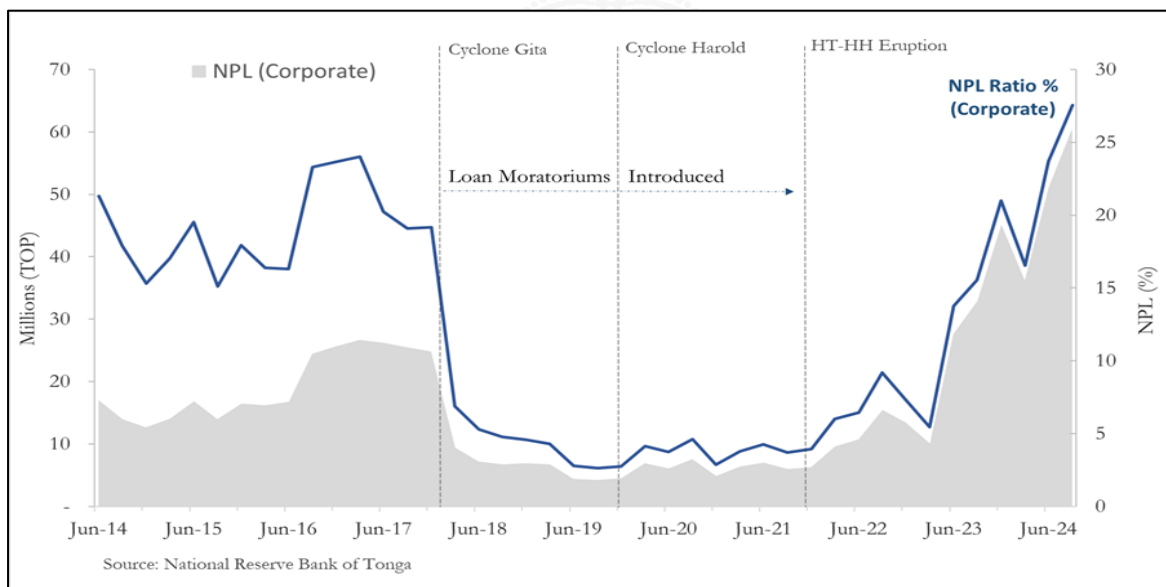
Figure 30 illustrates Tonga’s corporate credit growth compared to its long-term trend. From June 2023 until June 2024, corporate credit-to-operating surplus recorded a positive gap.<sup>24</sup> However, in the most recent quarter (September), Tonga’s operating surplus is now outpacing its credit growth indicating the beginning of a slump in corporate sector credit growth.

<sup>24</sup> Operating Surplus = nominal GDP at factor cost or GDP before taxes and subsidies.

### Corporate Sector Non-Performing Loans

The corporate sector's NPL was reported at \$58.4 million as at 30 September 2024. The corresponding ratio has continued to deteriorate since its low point of 2.6 percent in September 2019. Similar to the HH sector, loan moratoriums were introduced to specific businesses who could demonstrate being adversely effected by cyclone Gita in 2018 and were offered again on similar grounds following cyclone Harold in 2020, the COVID-19 pandemic, and the HT-HH volcanic eruptions. This is evident in Figure 3, where in March of 2018, the Corporate NPL ratio drops substantially from 19.2 to 6.9 percent. The majority of these moratoriums expired by March 2023 rapidly returning Tonga's NPL to its pre-Gita levels (above 20 percent) by December 2023. As a result the NPL was largely understated from March 2018 to March 2023.

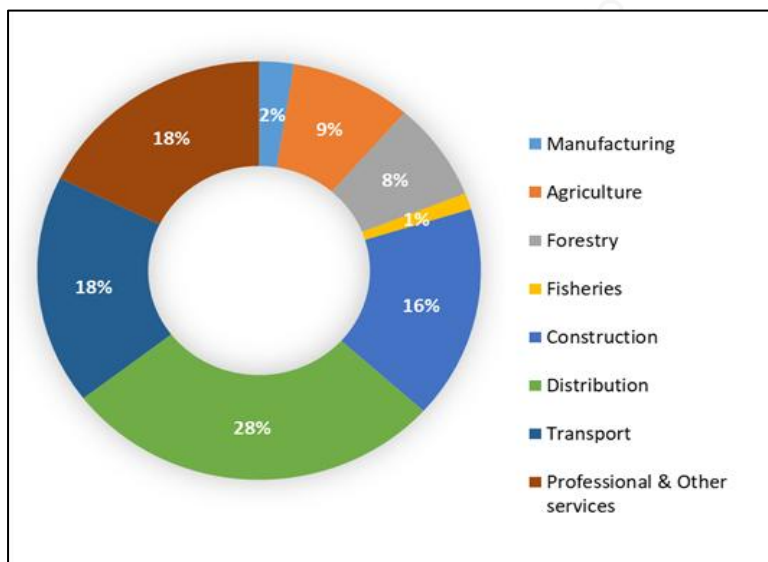
**Figure 3: Corporate Non-Performing Loans (NPL %)**



## Industry Sector Review

The Distribution sector holds the largest NPL among non-financial corporations at 28 percent (Figure 4), with an NPL ratio of 22 percent as of September 2024. Encouragingly, the NPL ratio for this sector has declined from 35 percent in September 2023, reflecting improvements in business activity and sentiment aligned with the ongoing economic recovery.

**Figure 4: Share of NPL by Sector for Non-Financial Corporations (September 2024)**



Source: National Reserve Bank of Tonga

In contrast, other sectors, particularly Transport, have shown a marked decline in loan performance. NPLs in the Transport sector rose sharply from 2 percent in March 2024 to 14 percent by September 2024. Given the industry’s vital role in supporting trade logistics within Tonga, heightened attention is warranted to prevent potential bottlenecks and disruptions that may arise from its deteriorating credit performance.

Additionally, NPLs in the Professional & Other Services sector—the second largest contributor to NPLs—have been increasing since April 2024, reaching 14 percent by the end of September. Historically, loans in this sector are vulnerable to natural disasters, such as tropical cyclones, which disrupt operations and damage infrastructure. NPLs typically revert to around 2 percent following a disaster, as businesses resume normal operations post-crisis. However, following the COVID-19 pandemic and the HT-HH volcanic eruptions, loan moratoriums provided by commercial banks kept NPLs at relatively low levels (1–2 percent). As these moratoriums have gradually expired, certain loans within this sector have been downgraded, signaling the prolonged impact of these crises on loan performance.

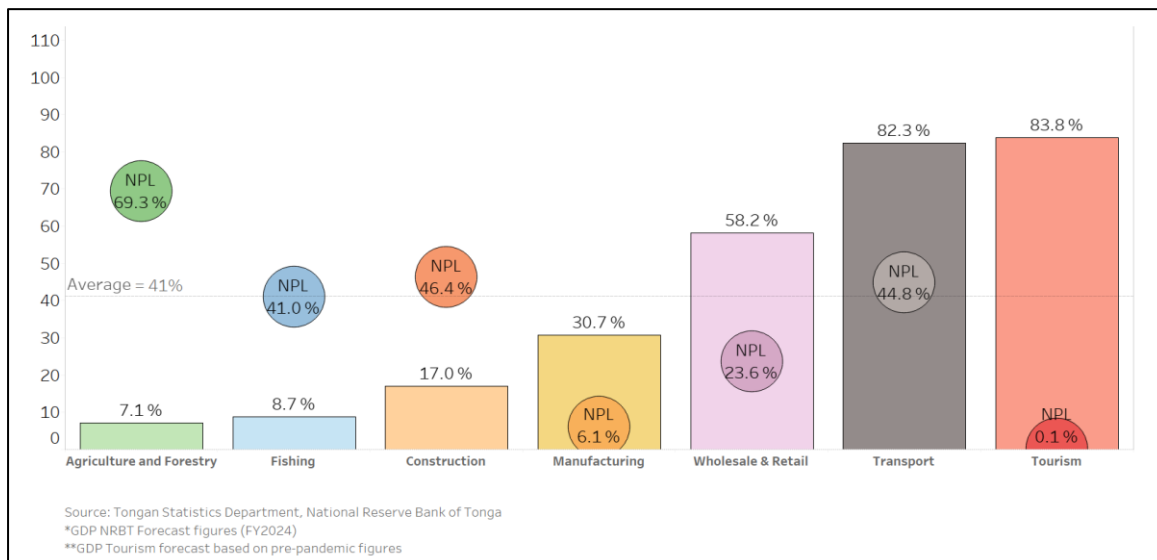
Collectively, the Distribution, Transport, and Professional & Other Services sectors account for 64 percent of total NPLs among non-financial corporations and 50 percent of total NPLs in the banking system. This concentration underscores potential risk exposure for banks should NPLs in these sectors continue to rise. Consequently, stringent regulatory oversight is needed, with banks encouraged to strategically diversify their loan portfolios and reinforce due diligence in credit assessment processes.

Figure 33, illustrates Tonga’s industry sectors by credit-to-output and reveals which industries are potentially over or under financed. The NPL ratio of each industry is also included to further analyse each sectors’ financial performance.<sup>25</sup> Through this examination we observe that credit for agricultural & forestry purposes is significantly underfinanced. Despite equating 14.6 percent of total GDP, it only accounts for 6 percent of corporate credit (1.8 percent of total credit). Furthermore, when we examine the NPL ratio for the agriculture and forestry sector we can

<sup>25</sup> Loan moratoriums are largely still in place for the tourism industry, hence the NPL ratio near zero, pre-COVID figures have therefore been used.

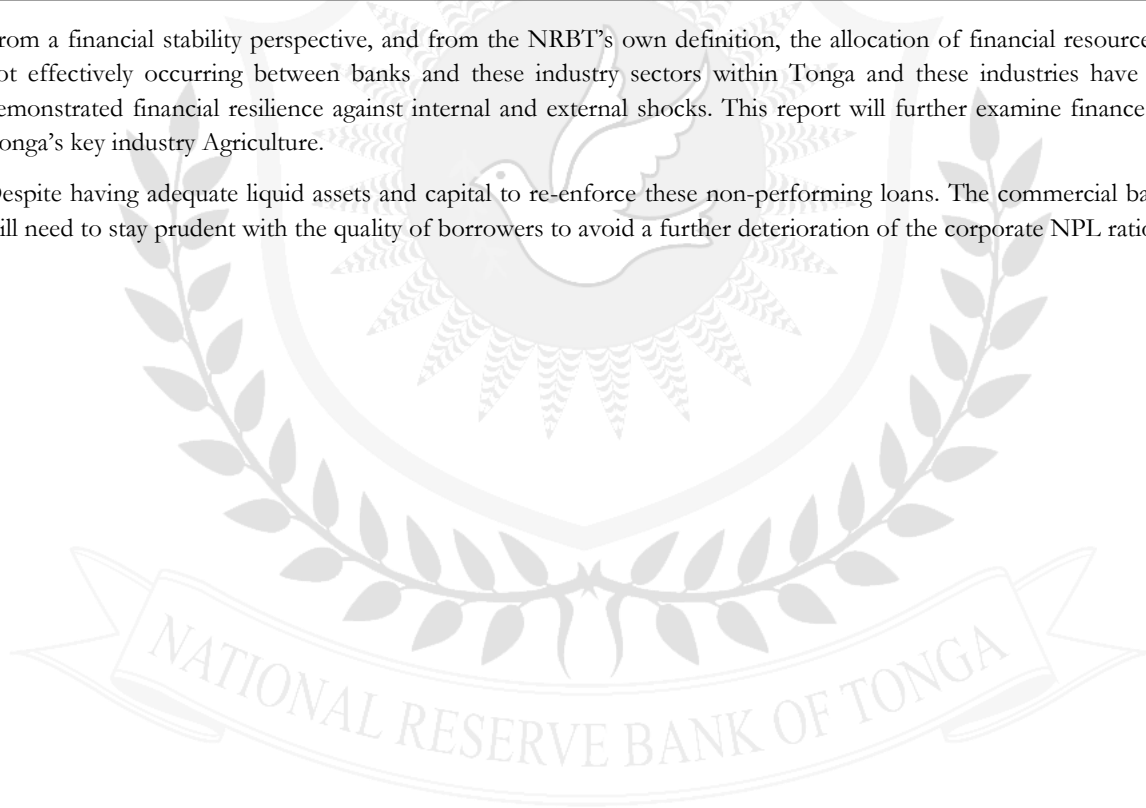
see that a staggering 69.3 percent of loans are non-performing. This is also true for both the Fishing and Construction industries, which are under-represented with 8.7 and 17.0 percent credit-to-output ratios respectively whilst both displaying NPL ratios above 40 percent.

**Figure 33: Industry Credit-to-GDP Contribution vs. NPL ratio (June 24)**



From a financial stability perspective, and from the NRBT’s own definition, the allocation of financial resources is not effectively occurring between banks and these industry sectors within Tonga and these industries have not demonstrated financial resilience against internal and external shocks. This report will further examine finance for Tonga’s key industry Agriculture.

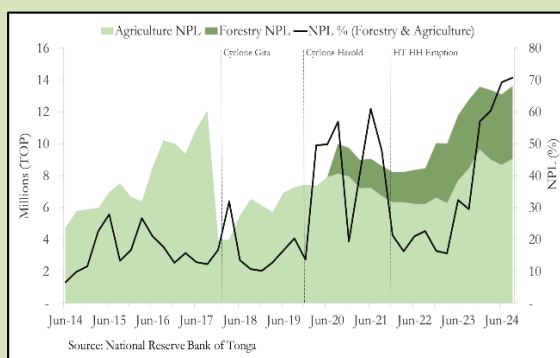
Despite having adequate liquid assets and capital to re-enforce these non-performing loans. The commercial banks will need to stay prudent with the quality of borrowers to avoid a further deterioration of the corporate NPL ratio.



## BOX A: Finance in the Agriculture & Forestry Sector

Figure 5 illustrates Tonga’s Total Agricultural & Forestry debt alongside the sector’s NPL ratio, which currently stands at a record high of 72 percent, far exceeding its long-term average of 27 percent. The sharp fluctuations in NPLs since September 2020 can be attributed to the introduction of debt in the Forestry sector. This debt was classified as non-performing between April and August 2021 and was again downgraded in October 2023 where it has remained ever since.

**Figure 5: Agricultural & Forestry Debt vs. NPL (%)**



### Fundamental Problems of Financing in the Agricultural Sector within Tonga.

Fundamentally, several factors make agriculture in Tonga unattractive to the banking sector. One key issue is the land allocation mechanism: each male over the age of 16 is entitled to a land allotment not exceeding 3.34 hectares. These allotments cannot be legally bought or sold among farmers<sup>26</sup>, which hampers the ability to achieve economies of scale. To expand operations, producers must lease additional land. However, land leasing is fraught with challenges, as most agreements lack formal contracts, leading to frequent disputes. The resolution of these disputes through the Tongan court system is both time-consuming and costly.

Additionally, the land tenure system limits the ability of landholders to use their properties as collateral for loans. From a financial perspective, leasing more land does not increase a farmer's tangible assets or improve

their collateral base. This increases the risk for financing operations, as the additional working capital required for larger areas is not backed by more substantial assets. Without sufficient scale, it is difficult for Tongan farmers to lower their per-unit production costs by investing in capital equipment, adopting new technologies, or implementing best practices.

Furthermore, the prevalence of small-scale farming means that most producers engage primarily in subsistence or semi-subsistence farming, with only about 5 percent participating in commercial agriculture.<sup>27</sup> This limits the division of labor, as Tongans with off-farm employment often split their time between farming and other work, hindering occupational specialization and contributing to economic inefficiency within the sector.

Another significant barrier to financing is the lack of formal record-keeping among subsistence farmers. Since much of their produce is consumed internally or sold informally, financial records such as profit and loss statements or audited accounts are rarely prepared. This makes it challenging for financial institutions to assess the viability of these farming businesses. Small-scale operations are also less equipped to invest in infrastructure that would make them more resilient to the adverse effects of climate change, such as the increasing frequency and intensity of tropical cyclones and the erosion or loss of low-lying coastal lands, further elevating the credit risk in the sector.

As a result of these factors, despite Tonga having some of the most fertile soils in the Pacific, only about 50 percent of available agricultural land is used for production, with the remainder left fallow. This situation is further exacerbated by the outward migration of Tongans seeking employment abroad, leaving a significant portion of allocated allotments vacant.

### Agricultural Banking

Due to the small scale, seasonal risks, unreliable collateral, and limited financial viability of most farming operations, commercial banks in Tonga are generally reluctant to provide financing for the

<sup>26</sup> Land can be gifted, however an individual's land holdings cannot exceed 3.34 ha's.

<sup>27</sup> Tonga-National-Agricultural Census (TNAC) Report - 2015

agricultural sector. As a result, 86 percent of the sector's total loans are provided by the government-funded development bank (TDB). The MOF has sought to stimulate lending in the sector through Government Development Loans, offering concessional loans of up to \$1 million at a 1 percent interest rate from October 2020 to May 2022, with a subsequent 3 percent rate for the remainder of the loan term. Additionally, the MOF and MAFF have supported the sector through PPP allocation grants, aimed at restoring growth post HT-HH eruption.<sup>28</sup>

While concessional loans and PPP grants are valuable tools for injecting funds into the sector, they do not address the fundamental financing challenges in Tonga's agricultural industry, as evidenced by the sector's concerning NPL ratio. Consequently, many farmers rely on alternative sources of funding, such as off-farm wage income, development grants, remittances, and non-bank lenders, to meet their working capital needs.

### Recommendations for the Agricultural Sector

A review into the way agricultural land is acquired is paramount to attract finance to the agricultural and forestry sector. Policy makers should seek to find ways to provide land owners more power to utilise the value

of their land as collateral against loans as well as improve the rights of producers operating on leased land by promoting formal contracts and decreasing the dispute resolution time-frame through the courts. Additionally, policy makers should implement targeted measures and promote the acquisition and utilization of appropriate technology to lower unit costs.

Furthermore, policies that improve the speed, complexity and cost banks have to endure in order to recover their bad debts should also reduce the credit risk and improve stability within the sector.

Additional research is required to better understand what is preventing banks from engaging in agricultural lending and what factors are causing the current loans to perform so poorly. Perhaps a purely development bank or an agricultural bank is needed to ensure enough funding is channeled towards this productive sector.

More frequent Tongan National Agricultural Census (TNAC) reports would be useful to identify the trajectory of the sector and the introduction of the NRBT's Banking Credit Survey should also help provide some insight to the barriers faced when lending to agricultural clients.



<sup>28</sup> Tonga Ministry of Finance – Budget Statement FY2024 - 25

## Annexure

### 1. The NRBT's Objectives and Functions

The NRBT implements a broad range of measures to promote financial stability. Section 4, 2014, of the Act (Amendment), set out the principal objectives of the Bank. This includes,

- (1) The principal objectives of the Bank shall be to maintain internal and external monetary stability.
- (2) Without prejudice to its principal objective, the Bank shall -
  - (a) promote financial stability; and
  - (b) promote a sound and efficient financial system
- (3) Subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth.

The Reserve Bank implements internal monetary stability by attempting to maintain a stable inflation below the reference rate of 5 percent.

Maintenance of external monetary stability is pursued through maintaining an adequate amount of foreign currencies (foreign reserves) to meet the country's foreign currency demands to pay for imports and other obligations. As such, the Reserve Bank's monetary policies aim to ensure that Tonga always has foreign reserve holdings of at least three to four months of import cover.

The National Reserve Bank Act, Section 4A also sets out the Reserve Bank's functions:

"The principal functions of the Bank shall be, to:

- (a) issue currency;
- (b) formulate and implement monetary policy;
- (c) prescribe the regime for the determination of the external value of the Tongan currency in consultation with the Minister;
- (d) determine the foreign exchange rate and implement foreign exchange policy;
- (e) determine and implement financial stability policy, and oversee the maintenance of the stability of the financial system as a whole;
- (f) regulate as required the supply, availability and international exchange of money;
- (g) exclusively hold and manage the external reserves of the Kingdom;
- (h) provide advisory services to the Minister on banking and monetary matters;
- (i) be the principal banker, fiscal agent and depository of the Government;
- (j) undertake banking business, in Tonga or elsewhere, subject to the provisions of this Act;
- (k) regulate and supervise financial institutions, including non-bank financial institutions;
- (l) oversee and promote the efficient, sound and safe functioning of the payment system;
- (m) collect and produce statistics;
- (n) cooperate with and participate in international councils and organisations, including public international financial institutions, and cooperate with domestic and foreign public entities, concerning matters related to its objectives and functions;
- (o) regulate and supervise capital markets in Tonga; and
- (p) to manage and promote financial inclusion initiatives and related activities; and
- (q) carry out any other function or any ancillary activities incidental to the exercise of its functions under this Act or any other Act.

### 2. Prudential Regulation

The review of the prudential requirements as outlined in the prudential standards continued with the assistance of the Pacific Financial Technical Assistance Centre (PFTAC) to ensure ongoing compliance with the Basel framework and international best practices. PFTAC's assistance in FY2023/24 focused on developing Excel-based templates for impact study of the implications of the revised prudential standards on banks. To enhance risk-based supervision, staff training in financial risk analysis of banks based on supervisory reporting was also conducted, while providing guidance on preparing individual bank risk profiles and a banking system risk report.

### 3. Prudential Supervision

As the economy recovers and the excess liquidity provides space for increased lending, enhanced supervision of banks continued with a risk-based approach. The increase in non-performing loans warranted more attention to assessment of credit risk management, including ensuring adequate provisioning, as well as the conduct of stress testing and analysis of potential shocks to the financial system. Attention was also on addressing new risk areas such as cybersecurity, which poses potential risks to financial stability as banks continue to digitise their services and operations.

Key supervisory actions during the year include:

1. 2 onsite visits to one bank particularly on credit risk management and 1 visit on cyber risk management
2. 12 monthly offsite analyses of each bank's position, performance and compliance with prudential requirements
3. 13 directives issued
4. 4 tripartite meetings with external auditors of banks
5. 1 meeting with Association of Banks in Tonga (ABT) and 10 bilateral meetings with banks

With the non-performing loans on the rise (driven and accounted for by one institution) posing risks on the sector's capital adequacy and balance sheet going forward, the Reserve Bank as the regulator targeted addressing the persistent weaknesses in operations to manage risks of distorting financial markets, and to preserve financial stability. Ensuring the safety and soundness of this bank is not only a fiscal imperative but it equally matters for economic development and growth.

Overall, systemic risks remain largely contained and the Reserve Bank plans to conduct more regular stress tests to ensure that banks maintain sufficient capital to absorb any potential losses.

The Bank hosted one roundtable during the year with the two retirement funds to further discuss the proposed extension of the Bank's supervisory authority to retirement funds, while also exploring opportunities for enhancing the efficiency and depth of financing to better utilize the excess liquidity in the banking system.

Our supervision of seventeen (17) licensed foreign exchange dealers aimed at improving compliance with both legal and regulatory requirements, which is critical to mitigate risks of de-risking or closure of their bank accounts. Furthermore, stronger systems and controls dissuade risks of being misused for facilitation of financial crimes. Key supervisory actions include:

1. 3 quarterly spot checks to 17 foreign exchange dealers
2. 1 annual compliance check visits to 17 foreign exchange dealers
3. 1 annual training for all foreign exchange dealers and 6 specific trainings for 6 foreign exchange dealers
4. Approval of 2 new agents
5. 1 enforcement action including revocation of 1 licence

The Reserve bank continued to increase the licensing of moneylenders during the year. We licensed 16 moneylenders in FY2023/24, taking the total number of licensed moneylenders to 103 moneylenders (12 with licence Type A, 38 with licence Type B, and 53 for licence Type C). Key supervisory actions include:

1. 1 training conducted for license Type A moneylenders on the Money Lender Act's requirements and license conditions, including the reporting requirements.
2. The reporting template was issued to 10 Type A. moneylenders for adoption effective October 2023.

Our supervision of the sole licensed microfinance institution (SPBD) continued to promote compliance with their license conditions and that the interest of their members is protected. Key supervisory actions include:

1. Reviewing draft prudential standards for the microfinance institutions and credit institutions developed with PFTAC assistance.

### 4. Financial Intelligence (Assessment of ALM/CFT measures in Tonga)

Based on the latest Mutual Evaluation Report (MER) for Tonga (2021), the country's level of compliance with the FATF's 40 Recommendations (Global AML/CFT30 framework) against money laundering and terrorism financing

reported, that although, there are policies and legal frameworks in place, much work is still needed to improve the country's level of compliance.<sup>29</sup>

The MER ratings indicates how well a country complies with the international standards for anti-money laundering and countering the financing of terrorism. These evaluations assess Tonga's effectiveness in fighting financial crimes that can undermine the integrity and stability of Tonga's financial systems. A higher MER rating reflects strong regulatory and legal enforcement frameworks for AML/CFT, building foreign investment confidence, credibility, and paving the way for wider global financial access and opportunities. Whilst a lower rating creates reputational risks, weakening investors' confidence, and reducing potential opportunities for foreign investment in the economy. This may also put pressure on sovereign credit ratings increasing Tonga's country risks profile and costs of borrowing (due to high-risk assessment).

Of the 40 recommendations, only one was assessed as compliant, whilst seven were largely compliant, nineteen partially compliant, and 13 non-compliant. The non-compliant assessments were largely due to weak and lack of enforcements of the MLPC<sup>30</sup> regulations. This is crucial as it also affects Tonga's compliance ratings (non-compliant) in relation to meeting correspondent banking requirements.

Moreover, there is a need to enhance collaboration and awareness with the non-banking financial institutions, individuals and businesses outside the financial sector, and improve on their understanding and awareness of the risks and implementation of preventive measures related to AML<sup>31</sup>.

In terms of Tonga's AML/CFT system, Tonga has low levels of effectiveness across all (11), except one Immediate Outcome (IO.2). A significant factor affecting effectiveness is the "lack of policy and operational priorities, with inadequate training, expertise and resources allocated to AML/CFT issues".<sup>30</sup>

The MER also identified six high-risk predicate crimes and six high-risk sectors relating to Money laundering and terrorist financing in Tonga. There are also rising concerns on cross-border cash smuggling given the significant cash economy in the country.

Tonga has the potential to improve on its MER ratings. It is fundamental that authorities collaborate proactively to strengthen and enforce the legal framework for MLPC, raise AML/CFT awareness across the country and draw closer working relationships with internal and external stakeholders. Capacity building and resource development also remains a key priority for key Intelligence Unit and authorities in Tonga.

## **FSR Going Forward**

Over the next 6 – 12 months the Reserve Bank's FSU is seeking to strengthen its approach by expanding its macro-prudential toolkit with the development and introduction of Tonga's own stress testing model for banks, insurance companies, and mutual funds to further its systemic risk analysis which can then be incorporation into policy decision making. Furthermore, the initiation of a bi-annual Banking Credit Survey with the goal of obtaining a better qualitative understanding of credit growth and NPL trends within Tonga. Extending the scope of the review into the non-bank financial sector, in order to cover the full scope of the financial system will also be a priority in the near to mid future.

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<sup>29</sup> APG MER Tonga, 2021

## Financial Soundness Indicators – September 2024

Core FSI		2019Q4	2020Q4	2021Q4	2022Q4	2023Q4	2024Q3
		%	%	%	%	%	%
<b>Capital adequacy</b>	Eligible capital to risk-weighted assets	27.2	28.2	31.7	32.3	32.2	31.7
	Total capital to total liabilities	24.9	22.5	22.7	22.4	24.1	21.6
	Total capital to total assets	19.9	18.4	18.5	18.3	19.4	17.8
<b>Asset quality</b>	NPL-to-total loans	3.2	3.7	3.6	5.9	11.8	13.4
	NPL-to-total capital	9.0	10.0	8.0	13.0	25.7	31.2
	Loan by sector: Business	47.1	47.1	44.8	47.0	49.4	48.3
	Loan by sector: Private Individuals	52.9	52.9	55.1	52.9	50.6	51.7
	Loan by sector: Others	0.0	0.0	0.0	0.0	0.0	0.0
	NPL by sector: Business	29.5	27.8	37.7	48.2	74.4	78.4
	NPL by sector: Private Individuals	70.5	72.2	62.3	51.8	25.6	21.6
	NPL by sector: Others	0.0	0.0	0.0	0.0	0.0	0.1
	Total provisions to total assets	1.7	2.4	2.1	2.4	1.6	2.0
<b>Liquidity</b>	Liquid assets-to-total assets	25.8	34.7	41.0	43.1	37.1	36.4
	Loans-to-deposit ratio	80.9	69.1	56.1	54.9	57.1	54.7
	Liquid Asset Ratio (LAR)	34.0	45.1	53.1	56.0	48.3	46.8
	Business loans-to-deposits	38.1	32.6	25.1	25.8	28.2	26.4
<b>Profitability (Year to date)</b>	Return on assets (after tax)	1.8	1.2	1.7	1.6	2.5	1.2
	Return on equity (after tax)	9.1	6.3	9.1	8.8	12.9	6.7
	Net interest rate margin (after tax)	4.0	3.4	2.6	2.5	2.8	2.2