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Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

August 12, 1996

To: Members of the Executive Board

From: The Secretary

Subject: **Fiji - Selected Issues**

The attached page 46 of SM/96/204 (8/7/96) was inadvertently omitted.

Att: (1)

Other Distribution:
Department Heads

affected the financial position of the bank when interest rates rose. Moreover, the short-term deposits proved volatile when government securities started to pay higher yields, straining the NBF's liquidity position.

Cyclical factors

Although the problems at the NBF were clearly endemic, the downturn in the economy that occurred in 1991 probably made them worse. It gave NBF management and government officials reason to believe that cyclical factors were a major reason for the problems. This may explain their reluctance to bring corrective policies to bear early on, persisting instead with the NBF's ambitious expansion strategy.

Fraud

Inadequate internal control systems and supervision created substantial scope for fraudulent activities within the NBF. There are allegations of interest-free loans being extended, kickbacks received, and uncompetitive tendering.

III. The Government's Plan

The government and the Reserve Bank acted decisively in August 1995 when a rehabilitation regime, formulated with technical assistance from the World Bank, was put in place. The senior management of the bank were replaced, lending to delinquent borrowers was stopped, and a comprehensive external audit undertaken. The government also reaffirmed its guarantee on all NBF deposits to help maintain investor confidence in the bank. The RBF started to monitor the nonperforming part of the NBF portfolio, and became represented on all internal committees (audit, lending, etc.) and the bank's board. In the first six months, the new management team focused on identifying the full extent of the problems. Collection activities were then stepped up, and two large foreclosures have already occurred. The strategy is not to forgive any debts, but to first concentrate on the large loans in order to establish credibility and to build up expertise.

An initial F$20 million was allocated in the 1996 budget to begin the recapitalization of the NBF. The subsequent comprehensive external audit revealed that the bank's problems were much more serious than assumed at the time.[2] Consequently, in May 1996, the government announced a more radical reform program, that would substantially downsize the NBF and change its character to that of a "personal savings bank," that is, a bank that will no longer have corporate customers, either as depositors or as borrowers. As a result, assets would be reduced to about F$60-100 million, and the NBF staff to around 400, from the current level of 700. Of course, such a restructuring will likely result in the assets of the bank

[2]The NBF's accounts for the year to June 30, 1995 have not yet been published, pending the issuance by the government of an indemnity consistent with its deposit guarantee.

becoming more concentrated in the rural sector, potentially leading to an increase in the risk of the lending portfolio.

Down the road, the government is willing to consider privatizing the NBF, but only to domestic interests, in order to retain at least one domestically owned bank. They further want the NBF to continue to provide banking services to rural areas which are not serviced by the other banks, but with an explicit subsidy from the budget. The fiscal cost of this subsidy is estimated at F$0.5-1 million per annum.

The management and recovery of the NBF's nonperforming loans will be assigned to an independent Asset Management Unit (AMU). This should allow NBF management to concentrate on reforming the bank. It should also help to minimize potential conflicts of interest between the AMU and the NBF, and promote correct transfer pricing between them.

The details of the downsizing of the NBF are not yet fully worked out. Various options are being considered for implementing the intended phasing out of wholesale and business deposits which is envisaged to take between 18 and 24 months. The government feels that a more rapid downsizing of the bank could disrupt economic activity and complicate the conduct of monetary policy. A financing solution must be found to spread the budgetary impact of the deposit guarantee over a reasonable number of years.

The new NBF will not be formally established before the government is satisfied with its commercial viability. Until the NBF Act has been amended to reflect the new character of the bank, the Minister of Finance will use his authority under the Act to direct NBF management to act accordingly. The government is also taking steps to prosecute the fraud that may have occurred.