

**Vanuatu: Assessment of the Supervision and Regulation of the Financial Sector
Volume I—Review of Financial Sector Regulation and Supervision**

This review of financial sector regulation and supervision in **Vanuatu** in the context of the offshore financial center assessment program contains technical advice and recommendations given by the staff team of the International Monetary Fund in response to the authorities of Vanuatu's request for technical assistance. It is based on the information available at the time it was completed on **July 2003**. The staff's detailed assessment of the observance of standards and codes can be found in Volume II. The views expressed in these documents are those of the staff team and do not necessarily reflect the views of the government of **Vanuatu** or the Executive Board of the IMF.

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**ASSESSMENT OF THE SUPERVISION AND REGULATION OF THE
FINANCIAL SECTOR**



**Volume I: Review of Financial Sector Regulation
and Supervision**

Vanuatu

July 2003

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ACRONYMS

AML	Anti-Money Laundering
BCP	Basel Core Principle
CFT	Combating the Financing of Terrorism
CP	Core Principle
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSF	Financial Stability Forum
FSP	Financial Service Provider
FTRA	Financial Transactions Reporting Act
IAIS	International Association of Insurance Supervisors
KYC	Know-Your-Customer
MFD	Monetary and Financial Systems Department
MOU	Memorandum of Understanding
NCCT	Noncooperative Country and Territory
OFC	Offshore Financial Center
RBV	Reserve Bank of Vanuatu
STR	Suspicious Transaction Report
VFSC	Vanuatu Financial Services Commission
Vt	Vatu (unit of currency)

*The IMF's Monetary and Exchange Affairs Department (MAE) was renamed the Monetary and Financial Systems Department (MFD) as of May 1, 2003. The new name has been used throughout the report.

PREFACE

In July 2000, the Executive Board approved a program of assessments on the basis of the paper “Offshore Financial Centers—The Role of the IMF,” published in July 2000. In this context, the government and the Reserve Bank of Vanuatu (RBV) invited the IMF to carry out an assessment of the extent to which the regulatory and supervisory arrangements for the financial sector complied with certain internationally accepted standards and measures of good practice. These include the prudential aspects of measures to combat money laundering.

The assessment took place in May 2002. The government indicated, when requesting the assessment, that they wished its scope to include not only the offshore market but also the domestic banking sector. Subsequently, during the visit of the mission, they asked that the scope be extended further to cover the domestic insurance sector. This was easily accommodated, since the offshore and domestic insurance sectors are covered by the same Act and supervised by the same agency. This assessment, therefore, covers all the main domestic and offshore sectors, as well as the prudential aspects of measures to combat money laundering. Since the domestic and offshore banking sectors are regulated under quite different statutes by different agencies and to different standards, the sectors were assessed separately, as reflected in this report. The overall assessment was carried out on the basis of the “Module 2” approach, as described in the above-mentioned paper of July 2000.

The mission undertook a review of all relevant current legislation and held discussions with the regulatory authorities, certain government officials, and a broad cross-section of the private sector practitioners. With some minor exceptions, the mission was unable to review regulatory documentation because of constraints imposed by the confidentiality provisions. Also, the resignation (immediately prior to the arrival of the mission) of the only person directly responsible for supervision of the insurance and trust companies sectors denied the mission an important means of reviewing practices in these areas. Attempts to invite the person concerned to meet the mission were unsuccessful. Finally, it should be noted that, at the time of the mission’s visit, Vanuatu was under a caretaker government pending the formation of a new administration following general elections.

The mission was led by Mr. Richard Chalmers, Monetary and Financial Systems Department (MFD). It included Ms. Cecilia Marian (Legal Department) and Messrs. Hideaki Suzuki (anti-money-laundering expert, formerly Head of the Japanese Financial Intelligence Unit), Dick Lang (banking expert, formerly Deputy Governor of the Reserve Bank of New Zealand), Gordon Rowell (Head of Insurance Supervision, Cayman Islands Monetary Authority), and Andrew Le Brun (trust and company services expert, Director of Policy and Legal at the Jersey Financial Services Commission). Ms. Megan Thomas (MFD) assisted with the report’s preparation.

This report has two volumes. Volume I discusses primarily those issues that the mission considers require the authorities’ attention and offers a series of recommendations, which are summarized in Appendix I. Volume II provides a principle-by-principle assessment of compliance with all the international standards that form the basis for the assessment.

In May 2003, the authorities submitted their formal response to the report, identifying the extent to which they planned, or had already taken action, to address the recommendations. The response shows a substantial level of acceptance and implementation of the recommendations. It is reproduced in Appendix II of Volume I.

The mission is most grateful for the excellent cooperation and hospitality received from government officials, the staff of the RBV, the Vanuatu Financial Services Commission (VFSC), and the State Law Office, as well as a number of private sector organizations and institutions.

EXECUTIVE SUMMARY

The assessment reveals a regulatory framework that is divided into two distinct parts. The domestic banking sector is supervised to a reasonably competent level under the auspices of the Reserve Bank of Vanuatu (RBV), and within the framework of the Financial Institutions Act. However, this must be seen in the context of the RBV primarily being a host supervisor for branches and subsidiaries of banks subject to competent home country supervision.

On the other hand, the entire offshore sector and the nonbank financial institutions within the domestic market, are subject to a low standard of supervision by the Vanuatu Financial Services Commission (VFSC) under legislation that, for the most part, is old and well out of tune with modern expectations. Moreover, while the jurisdiction was more advanced than many by introducing legislation, in 1971, to govern trust companies, it subsequently failed to enforce some of the law's key provisions, thereby undermining its potential value. The weaknesses identified in this report are largely the consequence of deficiencies in the legal framework and of the lack of resources, and are not intended to be a comment on the competence and dedication of the staff. Indeed, despite these handicaps, the VFSC has been successful, over the past year or so, in identifying a significant number of offshore banks requiring enforcement action.

With respect to the measures to combat money laundering and the financing of terrorism, Vanuatu has made important progress, but still has some way to go in making the system robust. The Financial Transactions Reporting Act (FTRA) was introduced quickly in September 2000, in order to avoid the threat of blacklisting by the Financial Action Task Force (FATF), but it now needs refining to bring it more fully into compliance with the standards. In addition, the other core anti-money-laundering laws were enacted in the late-1980s and require amending to reflect international developments since that time.

The legal and regulatory framework for the offshore sector is in urgent need of a complete overhaul. However, the mission considers that, before resources are devoted to this, the authorities in Vanuatu should reflect carefully on the current position of the country's offshore industry and consider where its future might lie. The reputational damage already inflicted by the prevalence of "shell" institutions has impacted, perhaps unreasonably, upon the domestic banks, and it is important that the authorities assess the true cost-benefit of hosting certain forms of offshore activity. Such an analysis will help to determine not only the real value of the offshore sector to the wider economy, but will also assist with determining the appropriate pace of any changes, and the most efficient allocation of scarce resources. The mission believes that delays in bringing about some restructuring of this sector can only result in further international pressures (both political and commercial), which will further disrupt the domestic financial market.

The division of supervisory responsibilities between the RBV and the VFSC places an unreasonable burden on the limited resources in the country. If the VFSC were to retain its supervisory role, it would need to undergo a major restructuring and expansion, which would further strain resources. In the circumstances, it would seem preferable to build on the existing strengths of the RBV and to consolidate within it the responsibility for all aspects of prudential supervision of both the domestic and offshore sectors.

The regulatory process in Vanuatu is hindered by an overriding concern for secrecy. Even where the laws clearly provide for access to information by the supervisors, there is resistance from the market to submitting to these powers. Disturbingly, this appears in part to reflect distrust of how the supervisors will use the information. Therefore, it is vital that confidence is built in the integrity of the supervisory authority and its staff. The supervisors must also be able to fulfill their international obligations with respect to the offshore sector; in particular, by having full legal authority to cooperate with foreign counterparts.

I. ACTION PLAN

1. A summary of all the recommendations contained in this report, together with an indication of their relative priority, is attached in Appendix I. The recommendations identify a substantial number of detailed remedial steps that the mission considers appropriate to bring the regulation and supervision into line with international standards. They mostly cover the offshore sector, in general, and the nonbank domestic sector. In order to provide the correct context in which the recommendations might be implemented, the mission suggests that they be considered within the framework of the action plan tabulated below.

2. This plan reflects the sequence in which the topics might be addressed most logically. Although some elements of the different stages might be pursued simultaneously, what is required in most cases will be contingent upon decisions at an earlier stage. However, stage 4 (enforcement), which has already been in progress for some time, should be treated as an ongoing priority and should be further expedited. The detailed recommendations summarized in Appendix I may be drawn on to assist at each stage.

Table 1. Action Plan

Stage	Topic	Action
1	Policy	Undertake a comprehensive review (in consultation with the industry) of the focus of the business activities in the offshore sector and of the regulatory resources available and determine the most appropriate future direction of the sector.
2	Regulatory	Review the RBV's capacity to assume responsibility for the prudential supervision; first, of the offshore banks and, second, of the remainder of the domestic and offshore nonbank financial institutions. Review the resource requirements for whatever overall regulatory infrastructure is preferred.
3	Legal	Conduct a review of the legal framework needed to support the conclusions of the policy review and seek technical assistance to enable prompt drafting of appropriate legislation.
4	Enforcement	Undertake a complete examination (with technical assistance where necessary) of the background and business activities of the existing licensed offshore banks and insurance companies, and identify those that fail to meet appropriate standards and pose a threat to the reputation of the jurisdiction. Take prompt action to remove those found to be unsuitable. Introduce strict standards of fitness and propriety for all existing and new licensees.
5	Secrecy	To assist with the enforcement process, enact immediate amendments to the offshore regulatory laws: <ul style="list-style-type: none"> • to permit regulator-to-regulator exchanges of information (both domestic and cross-border); • to remove any doubts about the powers of the regulator to access complete information from licensees; • to implement gateways for the regulator to talk directly to the auditors; and • to impose a "whistle-blowing" obligation on the auditors similar to that contained in the domestic banking law.
6	Assessment report	Consider the detailed recommendations contained in this report and incorporate them into the above processes, taking note of the respective priority attached to each.

II. POSSIBLE TECHNICAL ASSISTANCE REQUIREMENTS

3. The recommendations in the report identify a significant number of issues for the authorities' attention. While several of these are relatively straightforward and may be addressed without additional external input, the mission recognizes that further technical assistance may be required both to provide relevant expertise and to help implement certain measures expeditiously.

4. Such expert assistance will, in large part, continue to be provided by the IMF's resident technical assistance advisor, who has been attached to the Bank Supervision Division of the RBV since January 2002. However, further specialist resources may be necessary from time to time to complement those available locally. The key themes on which such assistance may be relevant are summarized below.

Table 2. Key Themes for Technical Assistance

Specialist Skills	Possible Assistance
Legal drafting	In support of the State Law Office, to draft and/or comment on appropriate changes in legislation resulting from the proposed review of the offshore sector and the regulatory framework (particularly, the International Banking Act and the Insurance Act), as well as recommended changes to the anti-money-laundering legislation.
Banking and insurance compliance	To assist the VFSC/RBV with the review of all existing licensees to establish compliance with basic prudential principles.
General offshore business	In light of the eventual decision on where to locate supervisory responsibilities, to provide training to the staff of the VFSC/RBV in the structure and risks associated with offshore financial services.
Governance of regulatory agencies	If a decision is taken to retain some or all of the regulatory responsibilities within the VFSC, to advise on an appropriate governance model, organizational structure, systems and procedures.
Financial intelligence units	To advise on the ongoing development of the FIU. (This is already captured within the current IMF regional program.)
Insurance supervision	To assist with the development of appropriate supervisory procedures, manuals and guidance notes, and to provide training for supervisory staff.
Supervision of trust companies	To assist with the development of appropriate supervisory procedures and to provide training in the general principles of the regulation of trust and company service providers.

III. BACKGROUND

A. Domestic Sector

Banking

5. The domestic banking sector comprises five commercial banks, including three branches and subsidiaries of Australian institutions, one government-owned institution, and a private bank; which, although it holds a domestic license, is not involved in the local market, but offers private banking facilities to nonresidents. In due course, two of the foreign-owned institutions

will be consolidated when ANZ (Vanuatu) completes the merger of its acquisition, in late 2002, of the local subsidiary of Bank of Hawaii. The domestic license permits a universal banking operation, servicing both resident and nonresident customers, but the focus of the banks is primarily on traditional retail and commercial activities. The trend in recent years has been a gradual withdrawal of foreign banks from the domestic market, as institutions have sought to consolidate and to close their marginal operations. This trend has continued recently with the sale of the Bank of Hawaii's business. The total assets of the domestic banking system, as at end-2001, were \$345.6 million, of which about 40 percent comprised local assets, the balance representing almost entirely deposit placements overseas, mostly by the foreign banks with their respective parent banks. About 15 percent of the deposit base was sourced from nonresidents.

Insurance

6. The domestic insurance sector comprises 12 insurance companies, 1 underwriting association, 7 insurance agents, and 6 brokers. Five of the companies are locally incorporated and eight are branches of foreign entities, mostly from Australia, Europe, and New Zealand. The market involves a mixture of life and nonlife companies, which mostly write property, motor, life, and health insurance. There is heavy reliance on overseas reinsurance, particularly for natural disaster cover. There are no accurate data for gross premiums or other relevant indicators.

Other financial institutions

7. The remainder of the nonbank financial sector comprises a number of credit unions that are active in the local communities, and some small savings institutions and cooperatives that offer deposit and loan facilities. The credit unions are supervised by an industry body, the Vanuatu Credit Union League, while the other institutions are established under specific Acts that define the limitation of their activities, but provide for no supervision. These institutions have not been included within the scope of this assessment.

8. The local securities market is almost non-existent and no account of it has been taken in this assessment. Six organizations are understood to have licenses to deal in securities under the Prevention of Fraud (Investments) Act.

B. Offshore Sector

Origin of the offshore sector

9. The offshore market in Vanuatu was established in the early 1970s at the initiative, mostly, of the British co-administration under the Anglo-French Condominium, in an attempt to generate economic activity to substitute for the declining agricultural sector. The core legislation was enacted in 1970–71, and much of it remains the basis for the current legal framework. The primary focus was originally on the English-speaking markets in the region, but progressive changes to legislation in these markets have forced realignment toward Southeast Asia and Hong Kong, in particular. The primary services have been offshore deposit-taking and the

incorporation of international companies (elsewhere frequently known as international business companies). The provision of trust services has declined significantly over the years and the market for captive insurance companies has never been developed to any great extent.

10. The offshore industry overall appears, at best, to have stagnated in recent years and has shown marked decline in some sectors. This may be attributed to a combination of factors: changed perceptions internationally of certain offshore banking structures; a slow response by the government and the private sector to changes in the market; a failure to maintain up-to-date legislation; increased competition in the region; and a perception among the client base that Vanuatu lacks political and economic stability.

11. The mission was unable to acquire comprehensive data on the current contribution of the offshore sector to the economy of Vanuatu. On a gross basis, it contributes less than \$1 million per annum to government revenues. The finance industry as a whole employs around 457 ni-Vanuatu, of whom about 300 work in the domestic banks and have little or nothing to do with offshore services. There was no information available on the additional “downstream” effects of the offshore sector.

Banking

12. At the time of the assessment, there were 34 licensed “exempt” banks that made up the offshore market, with total assets of about \$2.4 billion. The term “exempt” derives from the fact that under the Banking Act of 1970, which originally applied to both domestic and offshore banks, the offshore institutions are exempted from most of the prudential standards and reporting requirements that were applied to the domestic sector. At its peak, the offshore banking sector comprised over 100 institutions, but there has been a significant decline in numbers in recent years, largely as a result of moves by the authorities to “weed out” the market.

13. Five of the banks are subsidiaries of foreign banks, with the remainder having no apparent affiliation with established financial institutions overseas. Many are linked to trading companies in Southeast Asia, in particular, but a significant number are controlled by private individuals located in a broad spectrum of countries in Asia Pacific, Europe, and the Americas. The activities of the banks are not a matter of public record and the information held by the authorities is limited, but the VFSC understands that several are used primarily to provide “in-house” treasury operations for group companies. Since 1993, a condition has been attached to all new licenses requiring the banks not to advertise for, or otherwise solicit, deposits from the general public, but this restriction is far from being universally observed and the regulatory authorities in Vanuatu do not have the resources to enforce it.

14. Only three of the offshore banks have any form of physical presence in Vanuatu beyond the statutory requirement to appoint a local agent for the purposes of legal service. In most cases, the effective “mind and management,” and the books and records of the banks, are believed to be located in the jurisdiction in which the shareholders or controllers are resident. It is rarely, if ever, the case that the institutions have been required to obtain banking licenses to operate in these countries. This structure is typical of what are generally known as “shell banks.”

Insurance

15. The offshore insurance sector comprises 15 companies licensed to carry on business from within Vanuatu. Of these, very few maintain any form of physical presence within Vanuatu, apart from the statutory appointment of a registered agent for the service of notice. The mission was unable to obtain complete information on the type of business written in the offshore sector, but it is believed that the primary target market is the sale of tax-efficient policies into Australia.

Trust and company service providers

16. The trust and company service providers are incorporated as local businesses under the Companies Act, servicing both resident and nonresident clients. There are 10 entities licensed under the Trust Companies Act to conduct trust business, which is defined as the business of acting as trustee, executor, or administrator. Of these, eight provide services primarily to nonresidents, while the other two are purely linked to native title issues. Three of the offshore service providers are associated with international accounting firms and two with legal practices. The provision of trust services is not a significant feature of the offshore market in Vanuatu, largely because the use of trusts is not a part of the culture of Southeast Asia, from where much of the client base originates.

17. There are no complete data on the number of company service providers since this sector is not subject to licensing or regulatory requirements of any form. Several accountants, lawyers, and independent service providers are active in this field, providing company formation, secretarial, management, administration, and nominee services. They service approximately 4,342 international companies and 172 exempt companies on the Vanuatu register (i.e., companies prohibited from carrying on business in Vanuatu), and an unknown number of foreign-incorporated offshore companies. There is no reliable information on the activities of the international companies, but they are believed predominantly to be asset-holding and private investment vehicles, with ownership largely based in Australia, New Zealand, and Southeast Asia.

C. Regulatory and Supervisory Framework of the Financial Sector

18. At present, regulation of Vanuatu's financial sector is divided between two agencies. The RBV is responsible for the licensing and supervision of the domestic banking sector under the provisions of the Financial Institutions Act, 1999, while regulation of all other domestic and offshore sectors falls to the VFSC. However, the VFSC has limited executive powers, with responsibility for licensing and enforcement usually resting directly with the minister of finance.

19. The RBV (established in 1980) has a typical range of central banking functions, including the promotion of a sound financial structure, to be achieved, in part, by the regulation of the domestic banks. It has a staff complement of 53, of whom 4 are allocated to the banking supervision function. Immediately prior to the mission's visit, the director of bank supervision was promoted to deputy governor of the bank, but it was intended that he should also retain overall responsibility for bank supervision. The IMF placed a technical assistance advisor with the bank supervision division in January 2002.

20. The role of the VFSC (established in 1993) is very broad. It acts as registrar of companies, as well as being responsible for the regulation of the offshore banking sector, the domestic and offshore insurance sectors, and the local trust companies. The primary legislation¹ under which it operates for the purposes of this assessment includes:

- Vanuatu Financial Services Commission Act, 1993;
- Banking Act, 1970;
- Insurance Act, 1973;
- Trust Companies Act, 1971;
- Companies Act, 1986;
- International Companies Act, 1992; and
- Prevention of Fraud (Investments) Act.

21. It also administers several Acts relating to trademarks, patents, stamp duties, and charities. The VFSC has a number of statutory objectives, including to protect the public against financial loss arising from dishonesty, incompetence, and malpractice on the part of service providers, and to protect the reputation of Vanuatu as a financial center. It has a total staff complement of 13, including the commissioner, who is the only full-time employee represented on the board. Two staff are dedicated to the banking supervision function. Immediately prior to the mission's arrival in Vanuatu, the sole employee directly responsible for supervision of the insurance and trust company sectors resigned with immediate effect and indicated his intention not to return to the office.

D. Prior Assessments of the Financial Sector

22. Vanuatu has received three assessments of its financial sector in recent years. The main findings of these assessments are summarized below.

Financial Stability Forum

23. Subsequent to publication of its report on Offshore Financial Centers (OFCs) in relation to global financial stability (April 5, 2000), the Financial Stability Forum (FSF) published, on May 26, 2000, a categorization of OFCs "reflecting their perceived quality of supervision and perceived degree of cooperation." The FSF included Vanuatu within Group III, comprising jurisdictions that it considered fell significantly short of the standards adopted by countries in the other two groups.²

¹ The citations throughout this report have been standardized to reflect the date of enactment of the primary law. These may not, therefore, always accord with the formal short title of the respective Acts as contained in the Revised Laws of Vanuatu.

² The FSF stated in its press release of May 26, 2000, "...it is important to stress that the categorization of OFCs into these three groupings is based on responses of OFC supervisors and
(continued)

Joint APG/OGBS mutual evaluation report

24. The Asia Pacific Group on Money Laundering and the Offshore Group of Banking Supervisors conducted a joint mutual evaluation of Vanuatu in early-2000. That report made a number of recommendations to strengthen the anti-money-laundering (AML) system. The recommendations were taken into account in the drafting of the Financial Transactions Reporting Act (FTRA) implemented in September 2000.

Financial Action Task Force

25. Vanuatu was subject to review by the FATF in mid-2000, in the context of its exercise to identify Noncooperative Countries and Territories (NCCTs) in the fight against global money laundering. Vanuatu was not placed on the list of NCCTs.

IV. ASSESSMENT OF GENERAL ISSUES

26. This section of the report considers a number of issues that have common application to all sectors of the finance industry.

Cost-benefit

27. One of the difficulties faced by the mission, due to the lack of available information, was to determine the exact scale and nature of the activities in the offshore sector. This gives rise to a problem in assessing the risks and in assigning the priorities and resources that would best address those risks. In the absence of more substantive information, there is always the potential that the measures being proposed may be excessive for the actual circumstances. In compiling this report, the mission has been very conscious of the limited resources available within Vanuatu and the of need to offer recommendations that are both able to be implemented within the local environment and address the fundamentals of compliance with international standards.

28. While there are a large number of detailed recommendations, they are made in the belief that they meet these two criteria and that they will result in a regulatory system that is proportional to the scale and risk of the business. However, the recommendations also take into account the view that any jurisdiction that hosts international financial services should be willing and able to make a minimum investment in a regulatory regime that achieves certain core standards, irrespective of the size of the market.

the impressions of a wide range of onshore supervisors at a particular point in time. The categorization does not constitute judgments about any jurisdiction's adherence to international standards."

29. In light of this, the mission recommends that the authorities undertake a cost-benefit analysis of the offshore sector, not only to help determine its true economic and financial value, but also to provide further guidance on the nature of the risks and the future allocation of resources. A key risk to be considered will be the potential for further reputational damage to the jurisdiction. There appear to be significant differences of opinion within Vanuatu about the real contribution of the offshore sector to the economy and it will be important to improve the analysis. It is possible that this may lead to the conclusion that the cost of providing a necessary minimum standard of regulation for certain activities outweighs the long-term benefits and that it would make sense not to continue promoting those activities. Aspects of this are discussed further in the following sections of the report.

Future direction of the offshore sector

30. The offshore sector is at something of a watershed due to a combination of market conditions and international initiatives to combat the abuse of offshore centers for money laundering and regulatory evasion. As the detailed analysis in this report will indicate, the regulatory structure relating to the offshore sector in Vanuatu has numerous weaknesses that expose the center to potential abuse. In most cases, the standards of regulation reflect a legal framework that was established in a very different era when offshore centers were not seen as being integrated into the broader international financial system and when *laissez faire* attitudes prevailed. A modern “international financial center” that wishes to attain recognition as a part of the wider system can no longer work to standards of regulation that fall below accepted international practices. By so doing, a very clear reputational risk is created for the jurisdiction, which has economic implications far wider than just the offshore sector itself.

31. The mission recommends that, as a matter of urgency, the authorities, in consultation with the private sector, should undertake a fundamental review of the focus of the business activities in the offshore industry, of the regulatory framework, and of the direction in which they wish both to proceed. The review must take full account of the industry’s capacity to deliver a high-quality product and of the government to exercise effective and efficient oversight. The choices will not be comfortable, as there will be distinct financial and economic consequences of whichever of the two main options is pursued.

32. The “easy” option of leaving matters as they stand will result in increased international criticism of Vanuatu and its reputation generally will continue to suffer as a consequence of perceptions of the offshore sector. This has been a feature of recent years, but increasing pressure on overseas financial markets to mitigate the risk of abuse (e.g., as in the case of the USA Patriot Act) will translate into more direct action against centers perceived to be weak. This does not necessarily imply governmental action, but is more likely to be in the form of commercial decision-making within the market. For instance, many banks are already unwilling to process payments involving Vanuatu counterparties, not because of any specific concerns with the individual customer, but because the cost of undertaking enhanced due diligence (necessitated by the perception of the offshore sector) makes the business uneconomic. These problems will undoubtedly feed through more generally to undermine investor confidence in both the domestic and offshore sectors.

33. The “preferred” option of enhancing the regulatory regime and bringing it up to international standards also carries with it a downside. It will certainly be the case that several institutions in the offshore sector will prefer to migrate elsewhere, or close down altogether, rather than have to be open to greater scrutiny or to bear the extra cost of regulation. Realistically, it is unlikely that more than a handful of the existing offshore banks and insurers would find it attractive to submit to the conditions that would permit their operations to be supervised effectively by the local regulators. Equally, the need for greater transparency in the international companies sector can be expected to lead to a fall in the number of registrations. On the positive side, the jurisdiction should, over time, become more attractive to corporate business and financial institutions that have a greater need to operate in a well-regulated environment.

34. Such changes in the structure of the market will feed through, in the short term, into reductions in government revenues from license and registration fees, and may lead to employment pressures in the industry. However, the consequences cannot be accurately assessed, partly because the lack of transparency in the whole offshore sector makes it impossible to identify the underlying nature of much of the business conducted through Vanuatu. Moreover, a comprehensive review of the market should be an opportunity to identify areas for potential development that might substitute for the decline in some of the traditional products.

35. In reviewing the options, the authorities must take into account that the current practice of licensing “shell” financial institutions poses a fundamental obstacle to implementing effective supervision in line with international standards. The absence from the jurisdiction of any real “mind and management” or of the primary books and records of the institutions prevents the supervisory authority from undertaking most of the key procedures that form part of the core principles for effective banking supervision.³

36. The attempt, in part, to circumvent this problem by seeking to restrict the activities of the licensed banks to related-party transactions has been ineffective and cannot be properly monitored and enforced. The argument that, because these entities are supposed to be restricted to “in-house” activities, they do not require supervision to the same standard as other deposit takers is unsustainable. First, if indeed they are so restricted, there seems to be no justification in their being licensed as banks under the provisions of the Banking Act and, second, without a proper supervisory regime, there is no way of ensuring that the entities comply with the conditions of their licenses.

37. The only possible circumstance in which “shell” operations might be subjected to an effective regime is when the institutions are branches or subsidiaries of recognized international institutions and where the home supervisor accepts full responsibility for consolidated

³ Subsequent to the mission’s visit, the Basel Committee on Banking Supervision circulated among supervisors a paper entitled, “*Shell Banks and Booking Offices*,” in which it argues for the closure of shell banks on the basis that they cannot be supervised in accordance with accepted minimum standards.

supervision of the entity. Otherwise, all licensees should be required to maintain a physical presence in Vanuatu, where the supervisory authority may have access to the management, the books and records, the systems and controls, and all other relevant aspects of the business, as the RBV currently does for the domestic banks.

Legal framework

38. Whatever decision is made on the future direction of the offshore sector, it is essential that a substantial overhaul be undertaken of the legal framework. For the most part, the regulatory laws are based on concepts of the 1970s, with some subsequent amendments, and excessive reliance has to be placed on general company law, rather than on specialist financial services legislation. The consequence is that, however diligent the regulators might wish to be, their hands are tied by a lack of legal authority and powers to enforce their decisions. In effect, on a cost-benefit analysis, the human and financial resources currently devoted to the regulation of the offshore sector are largely being wasted.

39. The comprehensive review of the legal framework must be led by the government, using technical assistance where appropriate and available. Consultation with the private sector is an essential part of the process, but it should not be delegated to the private sector to develop their ideal of what a regulatory regime should encompass. To some extent, the risks of this approach can be seen from the fact that proposals for a new International Banking Act, which have fallen mostly to the private sector to develop, have been under discussion for over four years without any resolution.

40. If the decision is to move forward with a new International Banking Act, it is important that the implementation of the Act be taken as an opportunity to weed out institutions that do not meet current standards of integrity and to require remaining institutions to reach proper levels of financial standing. A generally adopted procedure in such circumstances is to require all existing licensees to reapply for authorization under the new legislation within a specified period (six months, for example). At this stage, the criteria relating to, in particular, fitness, propriety, and the need for a physical presence in Vanuatu, should be applied vigorously. Where significantly higher levels of capital are being demanded, there may be some scope for setting an immediate threshold at an intermediate level and then granting renewed licensees a further short grace period for full compliance with the new standards. A policy of automatically “grandfathering” existing institutions will result in serious regulatory difficulties and will do nothing to address the current weaknesses in the offshore sector.

Organization, independence, and resources

41. The detailed analysis, elsewhere in this report, of compliance with the international standards of regulation reveals a marked contrast between the supervision of the domestic banking sector and of the offshore industry generally. While the VFSC is disadvantaged by having to work under outdated legislation, the inescapable fact is that the regime overseen by the RBV is far superior when benchmarked against international standards. This is a structural issue and is not intended, in any way, to be a criticism of the quality and dedication of the VFSC staff

who, as regulators, are working under extremely difficult conditions. It is also recognized that the VFSC has made attempts to improve supervision of the offshore sector by seeking training for its supervisors.

42. Some of the weaknesses within the offshore regulatory regime stem from the very structure of the VFSC. Critically, the VFSC lacks any real decision-making authority, since this is largely vested in the minister of finance who can act against the advice of the VFSC, something that has happened on several occasions in the past.

The statutory composition of the VFSC Board comprises:

- The commissioner;
- The Governor of the Reserve Bank of Vanuatu;
- A member (appointed by the minister) who has legal qualifications or experience; and
- Four members (appointed by the minister), one of whom is a member of the Executive Committee of the Finance Center Association, and three of whom have previous knowledge and experience of financial business.

43. At the time of the assessment, there was a vacancy on the Board, with the appointment of the person with legal experience yet to be made. The indication latterly was that this appointment would now be made from within the government rather than from the private sector, as previously the attorney general had been an *ex officio* member, until the Act was amended in late-2001 to replace him with any legally qualified person. Of the other four members appointed at the prerogative of the minister, three are from the private sector.

44. Private sector input is valuable, since it offers, potentially, a broad spectrum of commercial, legal, and accounting experience. However, the VFSC's board of directors has substantial participation by private-sector practitioners, who have direct interests in the regulated sector. The current chairman (who is elected from among the members) is the chief executive of a financial services group, a part of which is subject to regulation by the VFSC and which provides agency services to other regulated entities. While the legislation builds in some important safeguards, this situation is far from ideal in a small, close-knit environment.

45. While a reorganization of the VFSC to create a more balanced structure is one perfectly reasonable option, the mission is of the opinion that it would be preferable to build on the strengths of the systems already developed within the RBV. A key consideration in coming to this conclusion is that, in a small country with limited financial resources and technical expertise, it appears a luxury to support two separate regulatory authorities. In addition, the governance arrangements for the RBV, where appropriate independent authority is vested in the executive of the organization, are in compliance with international regulatory standards, whereas those relating to the VFSC fall significantly short.

46. The argument for consolidating the regulation of the domestic and offshore banking sectors is compelling, since the expected standards of supervision are precisely the same for both and a suitable framework already exists within the RBV. While there may be differences of technique applied to achieve the desired oversight of the two sectors, it is contrary to widely accepted principles to assume that the offshore sector should enjoy a lighter touch, simply because of its lack of interaction with the domestic market. The systems being developed in the RBV are more robust than those within the VFSC, but the RBV should benefit from the skills and knowledge of the offshore market already acquired by the relevant staff of the VFSC.

47. It is less obvious that the RBV has a natural advantage in assuming responsibility for the nonbank sector from the VFSC, since this is outside its current scope of expertise. However, the maintenance of two separate authorities is inefficient in this environment and the mission strongly recommends that consideration be given to transferring all the prudential supervision functions into the RBV. This would include insurance (both domestic and offshore), trust companies, and the regime for company service providers recommended elsewhere in this report. The responsibility for the company registry and other nonprudential functions of the VFSC should be left within the current organization, of which the governance structure will need to be amended to reflect its reduced role.

48. The resource implications of moving all the supervisory functions into the RBV will need careful consideration. The current resources devoted to supervision of the offshore sector are insufficient for the task and would need to be increased very substantially if the number of licensees were to remain at their current level. However, the move to more effective supervision will undoubtedly lead to a significant reduction (in the short term, at least) in the number of institutions that the authorities consider meet the enhanced criteria for access to the market, or that wish to submit themselves to more rigorous supervision. A considered view on the appropriate level of resources needed for the RBV can only be taken after the state of the residual market has been identified.

Access to information

49. The mission was concerned about the prevailing attitude throughout the financial sector (both domestic and offshore) to the access to information by the regulatory authorities. Both the RBV and the VFSC (except in respect of the trust companies) have statutory powers to request whatever information they might need to assist them to carry out their duties. While it may not be a routine requirement, there are undoubtedly circumstances in which the regulators must have access to specific information on individual clients of licensed institutions (e.g., to check on compliance with account-opening procedures or to verify credit-risk controls).

50. From discussions with the regulators and the industry, it was apparent that the authority of the regulators to have access to such information was being ignored or challenged. In some cases, this appeared to be based on a belief that the provisions of the Financial Institutions Act, the Banking Act, and the Financial Transactions Report Act in this regard did not override the specific secrecy provisions contained in the Companies Act. In other cases, there was a general belief that some unspecified, but universal secrecy laws must, almost by definition, exist to

prevent such access. Finally, there was a disturbing perception that the regulatory authorities simply could not be trusted with the information and that it would be disclosed or used for other than supervisory purposes.

51. The legal authority for the regulators to access information must be clearly established and any potentially conflicting provisions overridden. At the same time, in order to give comfort to the industry that the information will be preserved and used properly, the provisions relating to professional confidentiality and integrity should be reviewed and strengthened, if required, but take note of the need to comply with international standards of regulator-to-regulator cooperation. Critically, any incidents where the information is misused should be pursued vigorously in order to convey the correct message to the industry and to the staff of the regulatory authorities.

Cross-border cooperation

52. One critical exception to the general principle of confidentiality of regulatory information is the ability of the supervisor to cooperate with both domestic and foreign counterparts. Such authority is provided to the RBV under section 55(3) of the Financial Institutions Act, and it routinely uses it in order to fulfill its responsibilities as a host supervisor for foreign banks operating in the local market. To the contrary, no such “gateway” exists in the laws administered by the VFSC. Indeed, the Companies Act binds the VFSC to absolute secrecy with respect to the affairs of exempt or offshore institutions (with respect to information collected under that Act), except in a very narrow set of defined circumstances.

53. Since, by definition, the offshore sector has a predominant international aspect, the ability to exchange information with overseas counterparts is essential for the integrity of the financial system, and to counter regulatory and criminal abuse. The VFSC is very conscious of the deficiencies in the existing legislation and attempts, as far as possible, to assist overseas counterparts. However, the staff cannot be put in a position where they may routinely be pushing beyond the perimeter of their legal authority, thereby exposing themselves to potential criminal liability. Therefore, whichever agency may be responsible for the supervision of the offshore sector in the future should be granted similar powers of cross-border cooperation to those contained in the domestic banking legislation.

Enforcement powers

54. Both the RBV and the VFSC (the latter through the minister of finance) have statutory powers to require licensed institutions to take actions to remedy problems that have been identified, or to fall into compliance with the law. In both cases, however, the powers are cast in very general terms, permitting the regulator to issue such directives, as it thinks fit. The absence of more clearly defined courses of action is unhelpful and, potentially, opens the regulator to a challenge that it might be acting unreasonably.

55. While the statute should not bind the regulatory authority to a predetermined list of remedies, it should provide a framework to help identify the range of options available. Typically, this would involve a hierarchy of remedial actions, ranging from the ability to set

differential prudential standards, through the power to levy administrative fines, and to require specific actions affecting management, leading ultimately to the power to revoke the authorization and bring about the orderly winding-up of the institution. While the Financial Institutions Act goes some way toward achieving this objective, the mission recommends that the provisions be reviewed and that a common basis be established for enforcement measures across all sectors, both domestic and offshore. It is preferable that these should be incorporated in the specific regulatory laws, rather than subsumed within any of the powers that might be exercisable over corporate entities, in general, under the Companies Act.

“Fit-and-proper” criterion

56. An essential feature of any regulatory regime for both prudential and anti-money-laundering purposes is to ensure that institutions are controlled and managed at all times by persons who are fit and proper to hold that responsibility. The Financial Institutions Act (section 13) and the Insurance Act (section 6) clearly provide for this at the licensing stage. In the case of the Financial Institutions Act, there are also provisions relating to subsequent changes of ownership, although there are no direct controls over future changes in management. Section 42 of the Financial Institutions Act disqualifies persons from being directors and managers of banks if they have been convicted of offences involving dishonesty, or are bankrupt or have been involved with a financial institution that has had its license revoked. The other regulatory laws affecting the domestic and offshore sectors (with the exception of the Trust Companies Act) are silent on the fit-and-proper criterion, apart from provisions that disqualify individuals from holding office for specified reasons (e.g., conviction of an offence involving dishonesty).

57. With respect to the offshore banks, the VFSC exercises its power to require the submission of whatever information it might wish at the time of application and, as a matter of practice, obtains a detailed personal questionnaire on shareholders, controllers, and directors. From this, it conducts due diligence enquiries for a range of overseas agencies. This may be a reasonably effective process at the time of entry to the market, but the offshore laws (with the exception of the Trust Companies Act) do not provide for prior notification of subsequent changes, and do not explicitly empower the VFSC to object to new shareholders or managers that it might regard as unsuitable.

58. The mission recommends that, in order to address this issue, the regulatory laws should include a requirement that the fit-and-proper criterion should be met on a continuous basis in respect of all persons who act as significant shareholders, controllers, and managers of any licensed institutions. This will also require that any changes in such positions should be notified in advance to the regulatory authority, and that the regulators should have the power to object to the new appointment. Where the appointments might take place without prior consent, the regulator should be empowered to force the removal of the individual, in the case of a manager, or to disenfranchise an undesirable shareholder or controller. An exemption, in the form of a post-event notification requirement for changes in significant shareholdings, should be applicable to institutions with publicly-traded shares.

V. ASSESSMENT OF DOMESTIC BANKING SECTOR⁴

A. Introduction

Structure of the sector

59. There are five banks licensed to conduct business in Vanuatu. Two (soon to be merged into one) are subsidiaries of ANZ Bank (Australia), one is a branch of Westpac Bank (Australia) and another, the National Bank of Vanuatu, is government-owned. The fifth, European Bank, is a small, privately-owned institution. The first four offer a full range of commercial and retail banking services, whereas European Bank offers a limited range of services targeted at high-worth individuals and companies, and its operations are almost entirely offshore. The National Bank has a widespread branch network throughout Vanuatu, whereas the two Australian banks operate only in Vila and Santo. All have been in business in Vanuatu for some years. Total assets, as at the end of December, were approximately Vt 50 billion (about \$350 million), of which about Vt 32 billion were held outside Vanuatu.

Legal framework

60. The RBV is responsible for the licensing and supervision of the domestic banks. The principal laws under which it operates are:

- Reserve Bank of Vanuatu Act, 1980;
- Financial Institutions Act, 1999.

61. The RBV Act provides, among other things, for the Bank “to promote a sound financial structure and to regulate banks,” while the Financial Institutions Act places a responsibility on the RBV to protect bank depositors. The latter Act also confers a number of specific powers on the RBV including: to issue and revoke banking licenses; to conduct on-site examinations; to request data; to place limits on the type and nature of business undertaken by banks; and to issue prudential guidelines.

Regulatory framework

62. Prior to issuing a domestic banking license the RBV is required to conduct a due diligence and assessment process covering ownership, management, proposed capital (source and structure), risk management, and accounting and internal control systems. Ongoing supervision is in accordance with the Financial Institutions Act, supplemented by various prudential guidelines issued from time to time by the RBV. The Act addresses minimum capital requirements; maximum exposure limits; restrictions on shareholdings; customer identification

⁴ Because the domestic and offshore banking sectors are subject to separate legislation and significantly different supervisory regimes by different supervisors, this sector assessment is in two parts, one covering domestic and the other offshore banking.

requirements; constraints on connected lending; credit risk management; loan classification; provisioning for impaired assets; liquidity ratio; and issues relating to the appointment and role of external auditors.

63. Monitoring is conducted through both on-site inspections and off-site analysis of data submitted to the RBV. Banks are required to submit monthly and quarterly data on assets and liabilities; profitability; large credit exposures and deposits; maturity profile of assets and liabilities; country exposures; exposure to related entities; capital adequacy; loan (asset quality) classification; and equity investments. In addition, banks are also required to comply with compulsory public disclosure requirements designed to facilitate monitoring of the financial condition. Audited copies of their annual accounts must be submitted to the RBV, published in the press, and made available to members of the public. The RBV also conducts on-site reviews of banks. Typically, these are held at least every two years and, at present, are largely confined to reviews of credit exposures and policies. In addition, the RBV conducts annual prudential consultations with the senior management of banks to discuss issues arising from on- and off-site analysis.

64. The Financial Intelligence Unit (FIU) of the State Law Office has prime responsibility for Vanuatu's anti-money-laundering activities, and a detailed description of its legislation and procedures are included in Part VIII of this report. The RBV maintains close liaison with the State Law Office and has reviewed the domestic banks' policy documents in relation to anti-money laundering. As part of its normal supervisory role, the RBV discusses these policies and their implementation with the banks.

B. Assessment

65. The assessment of the regulation and supervision of the **domestic** banking sector indicates that there is a high level of compliance with the Basel Core Principles, (BCPs).

66. The main empowering legislation, the Financial Institutions Act, is of recent origin (1999) and is modeled on an IMF draft, with some amendments incorporating aspects of comparable Australian legislation. In addition, a number of prudential guidelines have been issued, some of which have been based on their Australian equivalents. Prudential guidelines on the subject of 'customer due diligence' and 'fit-and-proper' requirements for management and directors of banks have been issued by the RBV subsequent to the mission's visit. Together, the legislation and guidelines meet most of the internationally accepted prudential standards as set out in the BCPs.

67. Supervision is provided by a specialist unit of the RBV. This has four permanent staff plus a temporary (IMF-sponsored) expert. It is headed by the RBV's deputy governor. All of the local staff have several years training and experience and actual supervision appears to be of a good standard. However, at present the RBV is "home" supervisor to only one bank, and if that were to change, further resources and skills may be needed.

68. The principal problem for domestic supervision is the spillover (in terms of reputational damage) from the poor legislation and supervision regime applying to offshore banks. The issue is dealt with in section IV covering offshore banks, in which it is recommended that the offshore legislation and supervision be brought into line with the domestic regime and that the two supervisory regimes be merged.

69. In the principle-by-principle examination of the present law and practice the domestic regime is assessed as being materially noncompliant with only two of the BCPs. The system is seen as compliant or largely compliant with all of the other principles except for two that were considered to be not applicable. There were no areas assessed as noncompliant.

C. Key Areas for Improvement

70. **Objectives (BCP 1.1).** The weaknesses of the offshore supervisory legislation mean that there is no consistency of treatment across the offshore and domestic sectors, and there is no provision allowing formal two-way communications between the two supervisors. However, the main cause of the problem is the provisions in the Banking Act covering the offshore regime, which does not provide for reciprocal cooperation. No action is recommended in relation to the domestic law or arrangements. This issue should be resolved by amendments to the offshore legislation.

71. **Capital adequacy (BCP 6).** The capital adequacy guideline technically falls short of what is required, as it does not incorporate any provision for market risk. However, as the level of market risk held by the Vanuatu banks is negligible, this is not a material omission at this stage. Nevertheless, for the sake of completeness it would be desirable to bring in market risk when the capital adequacy guideline is next revised.

72. **Other risks (BCP 13).** There is currently no procedure for assessing the range of operational risks. The mission was told that this weakness would be addressed when the RBV directs that banks' external auditors conduct a targeted audit review of banks' risk management procedures, including but not limited to operational risk policies and procedures. Under prudential guideline 5 and sections of the Financial Institutions Act the RBV can require that an audit report be prepared.

73. **Money laundering (BCP 15).** The overall issues relating to the prudential aspects of anti-money-laundering measures are addressed in section VIII of the report, which also contains a number of recommendations. The key development for the RBV to consider is the extension of its on-site examination program to include an assessment of the banks' anti-money-laundering systems and controls.

VI. ASSESSMENT OF OFFSHORE BANKING SECTOR

A. Introduction

Structure of the sector

74. The offshore banking sector consists of 34 licensed banks (down from a peak of 110 a few years ago), of which only three have a real physical presence in Vanuatu. The remainder are “shell banks” with no presence beyond either a resident “nominee” director or resident agent who acts mainly as a service address. All 34 are prohibited from undertaking business with Vanuatu residents, while those licensed since 1993 are also restricted under a general condition of their license from soliciting funds from the public in any jurisdiction. They may however, take deposits from associated and non-associated persons, provided they do not publicly advertise for deposits. Total known assets of the 34 banks, as at December 2001, were approximately \$2.4 billion, of which \$1.8 billion were recorded as market-related instruments and investments.

75. The authorities have very little information on the nature of the business of the offshore banks, but some are believed to be in-house treasuries for trading conglomerates. To the extent that this genuinely precludes the taking of third-party deposits, the risks, from a prudential standpoint, are relatively few. The mission was informed that the other banks are understood to be mainly associated with financial sector groups and are used principally to facilitate tax avoidance and/or asset protection schemes for themselves and their clients. Without further information on the scope and scale of such activities, it is not possible to define the level of risk involved. However, there has to be a presumption, based on the number of banks involved and the size of the asset base (some six times that of the domestic banks), that there would be a material risk to Vanuatu’s reputation resulting from a regulatory failure.

Legal framework

76. The main Acts covering offshore banks are:

- Banking Act, 1970;
- Vanuatu Financial Services Commission Act, 1993;
- Companies Act, 1986.

77. The Banking Act formed part of the original suite of laws designed to establish the offshore center. Until 1999, it covered both domestic and offshore banks, but with the enactment of the Financial Institutions Act it now applies to the offshore sector only.

78. The Act vests most of the executive powers in the minister of finance and exempts offshore banks, either overtly or by omission, from most standard prudential requirements, including capital adequacy and limits on large exposures or connected lending. It provides the minister with a general power to give directions to banks and this, together with his broad power

to revoke licenses, does provide an indirect method of imposing some requirements that are not specifically covered by the legislation. However, it is likely that any widespread use of this method of imposing controls would be subject to legal challenge.

Regulatory framework

79. Supervision is the responsibility of a statutory authority, the VFSC. The VFSC Board consists of a mixture of officials and industry representatives. Its chairman is one of the latter group. It has general responsibility for regulating and supervising the onshore and offshore financial sectors, except for domestic banks, and for advising the minister of finance on matters relating to the financial sector. Its banking supervision unit comprises of two staff who are responsible for supervising the 34 offshore banks.

80. The issuing of new licenses, enforcement actions, and the revocation of existing licenses is the prerogative of the minister of finance, acting on the VFSC's recommendation. Evaluation of new applications and ongoing supervision are the responsibility of the VFSC, and are directed primarily toward stopping banks from being acquired by criminals or used for criminal activities. There is a due diligence process on initial registration, with some follow-up of changes of ownership or management.

81. The VFSC has power to acquire information from licensed institutions, but not to pass it on to other regulators. Quarterly unaudited statistical returns and audited annual accounts are received from most banks, but analysis of the data by the VFSC is limited. A few banks voluntarily provide information on their capital adequacy, but this is not underpinned by any legal authority, in view of the general exemption from capital and other prudential standards provided in the Banking Act.

82. On-site inspections are confined (for cost and resource reasons) to visiting the locally based agent or resident "nominee" director, except for the three banks that have management and operations locally. As, in most cases, all the records of the banks are held offshore, the on-site visits are no more than general question and answer sessions. Recently passed anti-money-laundering legislation applies to the offshore banks, and some guidelines have been issued, but the authorities have not checked, through on-site processes, whether the banks are implementing the requirements (see section VIII of this report on money laundering for more details).

B. Assessment

83. The principal legislation (Banking Act) relating to the regulation and supervision of the offshore banking sector was first promulgated in 1970, and is reflective of the attitudes and standards then prevailing. At that time, banking regulation and supervision were aimed mainly at enhancing domestic financial sector stability and protecting domestic depositors. There was little concern about the stability of the global financial system or the interests of nonresident depositors. Since then, as a result of the huge increase in cross-border trade in financial services and in the volume of international financial flows, the international community now expects individual countries to regulate and supervise their banking systems with much broader objectives. No

distinctions are made between onshore and offshore banks and supervision is expected to be directed at (1) enhancing financial stability; (2) protecting depositors wherever resident; and (3) avoiding banks being used to facilitate criminal activities.

84. In the late 1990s, recognizing the need for updated legislation and supervisory processes, the authorities in Vanuatu commenced work on reviewing the banking legislation. A new Act was passed in 1999, covering the domestic banking sector, but progress on new legislation for the offshore sector stalled, and the work remains uncompleted after more than four years. Since the mission's visit, the VFSC Board has established a working committee that is now reviewing the earlier draft proposals, with the view to finalizing a submission to the government. Legislation has been introduced to combat money laundering that covers both the domestic and offshore financial sectors, but there have been delays in fully implementing its provisions.

85. The VFSC has attempted, constructively, to address some of the deficiencies in the offshore legislation through the use of directives, attaching conditions to licenses, implementing voluntary reporting systems, and developing informal communication channels with other supervisors. Some of these, however, are of dubious legality and are being ignored by some elements of the industry. Despite these constraints, the VFSC has been successful, over the past year or so, in identifying a significant number of banks that fall short of expected standards, and against which enforcement action has been considered necessary. This has resulted in a sharp decline in the number of licensed institutions. This process continues, and the mission strongly recommends that additional resources are applied (using technical assistance where possible) to complete the work as quickly as possible.

86. Given the age and widely acknowledged shortcomings of the present Banking Act, it is not surprising that a principle-by-principle assessment of the regime identified very few areas where current practice is compliant with the Basel Core Principles (BCPs). Overall, the weaknesses of the Banking Act severely restrict the VFSC's ability to implement and enforce normal supervisory processes. It has not been possible to assess the potential risk to depositors and to the market resulting from regulatory failure, due to the absence of reliable data and information on the banks' activities. Nonetheless, the reputational risk for Vanuatu is very real and has already crystallized to a great extent. There is a common perception outside Vanuatu that many of its offshore banks have been used for undesirable purposes, and the absence of a robust regulatory regime makes it difficult to dispel such perceptions.

C. Key Areas for Improvement

87. The most pressing requirement is for the Banking Act to be rewritten to bring its provisions relating to offshore banks broadly into line with those of the Financial Institutions Act. This should then be followed by implementation of guidelines and supervisory processes for the offshore banking sector that parallel those presently in place in the domestic sector. In addition, to enable the offshore sector to be supervised effectively, it will be essential for the revised legislation, after a brief transition period, to confine offshore licenses to banks that have a real physical presence (management and records) in Vanuatu, or that are subsidiaries or branches of banks licensed and appropriately supervised in their home jurisdictions. The

practical difficulties and cost that would be involved in trying to fully supervise banks that have their management and records offshore would be enormous and beyond the scope of the regulators in Vanuatu.

88. Vanuatu is fortunate to have in place legislation and a supervisory regime for domestic banks that provides a valuable model for addressing the deficiencies within the offshore sector. **As a result, the recommended action throughout this section, unless otherwise stated, is to implement provisions and processes on a par with those adopted by the RBV for the domestic sector.** Further, this review is based on the assumption that the overarching recommendation in favor of consolidating supervision within the RBV (see section II) will be adopted. If this is not to be the case, a governance structure, legal framework, and set of regulatory procedures similar to those of the RBV will need to be replicated in the VFSC.

89. **Objectives (BCP 1.1).** The VFSC Act clearly defines the role of the regulatory authority and provides it with appropriate objectives. However, the Banking Act lacks any real basis by which the VFSC can fulfill its objectives. This law was originally intended to cover both domestic and offshore banks, but its objective with respect to the offshore sector is apparent from the broad exemptions from any prudential requirements that it grants to offshore institutions. The VFSC is only able to exercise any authority in respect of prudential matters by the issue of directives on a general or case-by-case basis. The legal authority for this approach is uncertain.

90. **Independence (BCP 1.2).** All key regulatory decisions are vested in the minister, who may act entirely contrary to the recommendations of the VFSC, and against whose decisions there is no appeal. Cases have been encountered in the past, when applicants have been able to access the minister directly for decisions without going through the regulatory authority.

91. While private sector participation on the board of the regulatory authority can offer distinct benefits, the extent of its involvement with the VFSC appears excessive. Several board members are active participants in the financial sector, some of whom control institutions directly supervised by the VFSC. The chairman is the chief executive of one of the biggest players in the local market. Only one of the board members has any executive capacity within the VFSC, and the necessary provisions to exclude the board from any involvement in individual cases (because of its composition) prevents the commissioner from having appropriate support at a senior level within the agency.

92. **Legal framework (BCP 1.3).** The Banking Act provides for the granting and revocation of banking licenses by the minister of finance, in consultation with the VFSC. This Act was originally introduced to cover the regulation of both domestic and offshore banks, but now relates only to the offshore sector following the introduction in 1999 of the Financial Institutions Act for the domestic banks. Offshore banks are specifically exempted from the capital and other prudential norms specified in the Banking Act. There is provision for the VFSC to issue directives, but the Act appears to limit this power to specific circumstances, and does not explicitly permit it to be used to set general prudential rules. A 1995 amendment to the Act gives the VFSC the power to conduct examinations of the banks and to require the submission of information. However, many of the banks believe that the disclosure of customer information, in

particular, is prohibited under section 381 of the Companies Act, which provides for extensive secrecy in relation to the affairs of “exempt” companies, which includes the offshore banks. As a result, several are refusing to supply information to the VFSC.

93. **Enforcement powers (BCP 1.4).** In principle, the minister has the power to apply any control or sanction under the sweeping powers of section 17 of the Banking Act. However, the absence of a broader menu of specific, graduated options creates uncertainty as to how the minister might use this power, and could expose decisions to a challenge on the grounds that they are unreasonable and do not have any basis in law. In addition, the VFSC has no overt powers to ensure compliance by the banks.

94. **Information sharing (BCP 1.6).** There are no legal “gateways” within the regulatory laws, under which the VFSC can exchange information, and otherwise cooperate with other domestic and foreign regulators. Attempts to remedy this by adopting informal procedures expose VFSC staff to criminal sanctions. The VFSC is also covered by very restrictive secrecy provisions in relation to exempt companies, including offshore banks, under the Companies Act.

95. **Permissible activities (BCP 2).** The sanctions for carrying on a banking business without a license (approximately \$350 per day) are unlikely to pose a serious deterrent in many cases.

96. **Licensing criteria (BCP 3).** The Banking Act does not specify any objective criteria for authorization. This leads to uncertainty about what is required, as a minimum, for entry to the market. Although the VFSC does seek to impose some “fit and proper” and other tests to applicants, the legal basis for the criteria that it sets (e.g., initial capital) is uncertain, at best. The VFSC’s practice to deal with applications on a purely paper basis, and not to require direct face-to-face contact with the applicants, denies it an important tool in its assessment of compliance with the criteria that it seeks to set administratively.

97. **Ownership (BCP 4).** The absence of any direct, overt controls over subsequent changes of beneficial ownership counters the VFSC’s attempts to impose “fit-and-proper” tests at the time of licensing. The banks are required to file details of their shareholders on an annual basis under the Companies Act, but this does not extend to disclosure of beneficial ownership, potentially resulting in the VFSC losing sight of where control ultimately rests.

98. **Investment criteria (BCP 5).** There are no controls over, or notification requirements for, investments in subsidiaries or affiliates. This not only hinders the VFSC’s ability to assess overall risk, but also prevents it from determining whether or not it has a responsibility to undertake supervision on a consolidated basis.

99. **Capital adequacy (BCP 6).** There are no minimum statutory capital requirements for entry to the market. The across-the-board figure of \$150,000 used on an administrative basis by the VFSC is very low and takes no account of the risks that the institution will be undertaking. While some attempts are being made by the VFSC to monitor capital on an ongoing basis, the data it receives does not permit any meaningful assessment, and it lacks the legal authority to require improvements, if it were to consider this to be necessary.

100. **Credit policies (BCP 7).** The nature of the offshore banking sector, where only three institutions have any form of physical presence in Vanuatu, makes it impracticable for the VFSC itself to verify the standard of the practices within the banks. Furthermore, no use is made of the external auditors to review and report on these issues in the course of their work. Such an option was explored, but the banks were resistant to having to meet the costs of expanding the audit beyond the specific requirements of the Companies and Banking Acts. It was estimated that, were the VFSC to absorb the costs, it would require up to Vt 1 million, which is well beyond its resource capability.

101. **Loan evaluation and loan-loss provisioning (BCP 8).** The VFSC has not implemented any guidelines on loan-loss provisions, and, through lack of reliable data and effective on-site procedures, has no basis on which to assess the adequacy of any provisions that might be reported by the banks.

102. **Large-exposures limits and connected lending (BCP 9 and 10).** An argument has been made that, because the offshore banks have restrictions limiting their activities to “in-house” operations, there is no need to apply controls on large exposures or related-party transactions. In practice, however, this restriction does not limit the range of the banks’ activities to the extent often claimed, and it is apparent that their customer base extends beyond related parties. Therefore, the ability to apply a large exposures policy remains an essential feature.

103. **Country, market, and other risks (BCP 11–13).** The extent to which this is a material factor is unclear, due to the absence of any data on the cross-border activities of the banks. The prevailing lack of knowledge, within the VFSC, of the exact nature of most of the banks’ business makes it impossible for the regulator to determine the extent to which certain risk measurement and controls should be implemented.

104. **Internal control and audit (BCP 14).** The inability to conduct any form of meaningful on-site examination (due to the absence of most of the banks from the jurisdiction) puts an assessment of these issues outside the scope of the VFSC. In addition, since there is an almost total lack of direct contact with the management of the licensed institutions, the VFSC is denied a tool to gain an impression of the control environment and of the quality of management. There is no policy on the need for an internal audit function, and the VFSC does not have access to any reports that might be produced where such a function does exist. No use is made of the external auditors to report on the control environment during the course of their work, and the auditors are prevented by statute from discussing the clients’ affairs directly with the VFSC. Again, the banks have refused to meet the cost of having the audit extended beyond the strict statutory requirements.

105. **Money laundering (BCP 15).** Vanuatu has enacted a range of laws in relation to money laundering (see section VIII of the report). These laws apply in all respects to offshore banks, and the VFSC has issued a series of *Practice Notes* to the sector. However, the VFSC has no procedures in place to verify that the banks have adequate systems to combat money laundering and that they are complying with their legal obligations. A requirement by the FIU that all banks should submit copies of their anti-money-laundering policy manuals had been rejected by five

offshore banks on the grounds that such controls are irrelevant to their business. However, since the mission's visit, all have now indicated that they will comply, following directions from the VFSC.

106. **On-site and off-site supervision (BCP 16).** There is no effective form of on-site examination in place, and the nature of the offshore sector makes it impracticable for the VFSC to implement an effective system. The alternative option of using the external auditors to perform some functions on behalf of the supervisors is not employed, and is effectively precluded for cost and practical reasons, and by the secrecy provisions within the legislation. The move made a few years ago to introduce a reporting system to provide the basis of an off-site surveillance process was a positive development, but has not addressed the issue satisfactorily (see BCP 18).

107. **Bank management contact (BCP 17).** The VFSC makes occasional requests for meetings with the management of the offshore banks. These are rarely agreed to by the banks, largely because of the cost and inconvenience of having to travel to Vanuatu, but also because they do not believe that the VFSC has the authority to inquire into their affairs. As a result, the VFSC can only rely on the local agents acting as intermediaries in passing requests for information. This process is a serious obstacle to the VFSC's ability to understand the operations of the banks.

108. **Off-site supervision (BCP 18).** The introduction of a quarterly reporting system was a positive step. However, not all the banks are complying with the request for data and the VFSC appears to have no authority (or will) to enforce compliance. The data captured in the returns is far from comprehensive and does not permit a proper assessment of capital adequacy or other prudential norms. Moreover, there is no mechanism for verifying that the data submitted is accurate, and the VFSC has experience of cases where the quarterly data varies significantly from the corresponding data in the audited financial statements. The apparent conflicting interpretations of the law with respect to the VFSC's powers to obtain information from the banks restrict the development of the off-site process. The amendment to the Banking Act post-dates the Companies Act provisions and would normally be considered to have overriding force. However, as long as this remains untested in the courts or is not put beyond all doubt by further amendments to the law, the VFSC's unwillingness to press for disclosure weakens its authority.

109. **Validation of supervisory information (BCP 19).** There is no mechanism for validating the supervisory returns. The VFSC is not in a position to undertake a relevant on-site procedure itself, and there is no obligation imposed on the auditors to check the accuracy of the quarterly returns.

110. **Accounting standards (BCP 21).** The VFSC relies entirely upon the external audit process, but has no mechanism either for determining and verifying the standards to which the audits are completed, or for communicating with the auditors on issues relevant to the audit. Indeed, the auditors are prevented by the secrecy provisions from communicating directly with the regulators. In addition, the institutions are based entirely outside the jurisdiction and the

audits are usually undertaken by foreign auditors applying the standards applicable in their home country. This prevents the VFSC from having a clear understanding of the basis of the accounting standards or of the consistency of approach across the sector. There is no requirement for offshore banks to publish any form of financial data on their activities, even where they may be taking deposits from the public.

111. **Remedial measures (BCP 22).** In principle, the VFSC, acting through the minister, would appear to have a wide range of enforcement powers, given the broad discretion permitted under section 17 of the Banking Act. However, these powers are too general and do not explicitly provide for a range of graduated options that are transparent and subject to appropriate checks and balances. In addition, all the powers are vested directly in the minister, and the VFSC itself has no apparent authority to take action of its own accord. The practice of issuing directives to overcome this weakness has an uncertain basis in law. The most common form of enforcement measure adopted under the Banking Act appears to be revocation of the license. There are no measures that allow the supervisors to take control of the institution to ensure that the assets are protected and that there is an orderly winding-up and distribution.

112. **Supervision over foreign banks' establishments (CP 25).** The absence of any "gateways" for regulator-to-regulator exchanges of information prevents effective supervision of banks' cross-border activities. Any attempt by the staff of the VFSC to share information potentially exposes them to criminal liability under the Companies Act. Although the VFSC is not known to be the home supervisor for any bank with overseas operations, virtually all the licensed banks have their operational base overseas. Therefore, it is essential that the VFSC should be able and willing to communicate on a confidential basis with fellow regulators.

VII. ASSESSMENT OF THE INSURANCE SECTOR

A. Introduction

Structure of the sector

113. At end-December 2001, 12 domestic insurance companies, 1 underwriting association, 7 insurance agents, 6 brokers, and 15 offshore insurance companies were licensed under the Insurance Act. Of the 13 domestic insurers, 5 are locally incorporated companies subject to home regulation in Vanuatu and 8 are external "foreign branch" operations, subject to host regulation. The majority of these companies are based in Australia, Europe, and New Zealand.

114. The domestic insurance market in Vanuatu is small, comprising a mixture of life and nonlife companies that predominantly write property, motor, life, and health insurance. Supervision covers only private insurance, which is largely related to property, where rates have increased significantly in 2001, due to global hardening of the reinsurance markets. Rates are primarily driven by the market forces, as opposed to corporate underwriting practices.

115. Complete market statistics for the year ending 2001 are not available. The only available figures for 2001 estimate that gross property premiums of the licensed insurers were approximately Vt 320 million. In general, the domestic market is heavily reliant on overseas reinsurance, particularly for cyclone, flood, and earthquake catastrophe cover. The main domestic distribution channels are through agencies or on a direct basis. All agents, brokers, and salesmen are required to be licensed under the Insurance Act.

116. No data is available publicly, or was provided to the mission, on the type of companies that write offshore insurance business, although the primary market for such companies appears to be Australia, and the business may be linked to investment schemes rather than traditional insurance products.

Legal framework

117. All organizations carrying on business in or from within Vanuatu are required to be licensed either as a local, external, or exempt insurance entity. The relevant legislation includes the Insurance Act, 1973, and the Companies Act, 1986. The Companies Act specifically provides for certain filing and statutory requirements for exempt companies, which include the offshore insurance sector.

118. The Insurance Act is subdivided as follows:

- Part II sets out the regulation and licensing requirements for insurance companies (with the exception of associations of underwriters, e.g., Lloyds), administration and accounting requirements, investigation responsibilities, judicial management, and winding-up;
- Part III sets out requirements for associations of underwriters;
- Part IV sets out the regulation and licensing requirements for agents, insurance brokers, and salesmen;
- Part V specifically exempts “offshore” insurance companies from certain provisions of the Act, including the statutory filing requirements, and the fit-and-proper tests;
- Part VI refers to the general powers and duties of the regulator, and covers the powers to waive certain requirements of the Act, to carry out investigations and on-site inspections, and to petition for the winding-up of a licensee; and
- Part VII contains miscellaneous provisions regarding the use of the word insurance, jurisdiction of the courts, borrowing powers of directors, and legal protection for the insurance supervisor.

Regulatory framework

119. The VFSC is responsible for the supervision of all entities licensed in the domestic and offshore insurance sectors through its adoption of the powers of the Registrar for the Administration of Insurance Companies under the Insurance Act. The acting supervisor of insurance and compliance (the supervisor of insurance) was the only dedicated resource charged with the responsibility for regulating the insurance sector in Vanuatu. At the time of the mission's visit the insurance supervisor had resigned and was not available for any meetings. A number of key functions of the VFSC can only be effected with approval from the minister of finance. These key areas include licensing, investigations, and sanctions. The VFSC has legal protection pursuant to Section 54 of the Insurance Act to perform and exercise its powers.

120. The supervisory process in Vanuatu focuses solely on traditional off-site supervision. The process revolves around the licensing and monitoring of the companies. This monitoring primarily involves the inspection of audited annual financial returns. The responsibilities of the VFSC are broadly outlined in the Insurance Act, but these are further clarified for operational purposes within the contract of employment for the insurance supervisor.

B. Assessment

121. Although the domestic insurance market is small by global standards, it remains significant for the local economy partly because Vanuatu has particular exposure to natural disasters. Regulatory failure could result in serious weaknesses in the structure of the industry, leading in turn to an adverse impact on the wider economy.

122. As indicated in the introduction to this section, there is little information available on the size and structure of the offshore insurance market, and, therefore, it is difficult to quantify the risks arising within this sector. However, in general, the risks are considered to be significant when small jurisdictions seek to attract such business, including the probable involvement of foreign residents in some part in the procurement process, the attendant difficulties with due diligence, and a high reputation risk, should a licensed company fail. In terms of the reputation risk, the size of the market frequently has little bearing if the external perception is that the sector is subject deliberately to only a light regulatory touch.

123. The overall impression is that insurance business in Vanuatu is supervised to a standard that falls well short of those expected under the core principles (CPs) established by the International Association of Insurance Supervisors (IAIS). The mission considers that Vanuatu is observant of 1 principle, materially non-observant of 11, and non-observant of 4, while 1 principle is not applicable.

124. The Insurance Act is silent in a number of key areas. In particular, it does not require that key functionaries of offshore companies should be fit and proper; does not define requirements for changes in beneficial ownership; allows for only one enforcement action (being cancellation of the license); does not provide gateways for exchange of information with other regulators; and does not specify detailed requirements for annual returns. Moreover, the Act exempts

offshore insurers from a number of key prudential regulations, as it was designed specifically to reduce the ongoing requirements for such companies; particularly, with respect to capitalization, due diligence, sanctions, and statutory filing requirements.

125. The VFSC lacks operational independence. Key decisions are presently made by the minister of finance, upon recommendation from the VFSC, which acts more in the capacity of a registry than a central regulatory authority. For example, the licensing stage includes the submission of a number of critical documents, including business plans and background information on key functionaries. However, very little, if any, analysis of these documents is evidenced. Thereafter, ongoing supervision is mostly limited to a cursory review of the annual returns. Vanuatu, like most small markets, faces serious difficulties in obtaining skilled staff, and the resulting shortage at the VFSC has been detrimental to the supervision of the insurance industry.

126. In summary, it is recommended that consideration be given to a complete revision of the Insurance Act, particularly in the areas of regulatory independence; licensing; fit-and-proper tests; financial reporting; on-site inspections; cross-border cooperation; and sanctions. This would then provide the basis for the development of appropriate regulatory procedures.

C. Key Areas for Improvement

Organization (Principle 1)

127. The regulatory system is marked by a lack of operational independence for the VFSC, an absence of transparency of process, insufficient expert resources, and a legal infrastructure that is in need of substantial revision.

128. The Insurance Act provides that the minister responsible for commerce (now taken to be the minister of finance) makes all decisions, with respect to licensing and regulatory matters, upon advice from the VFSC. There is evidence that operational independence can be interfered with and it is not a structure that lends itself to efficiency or professional integrity.

129. Prior to the visit of the mission, there was one full-time insurance supervisor who was relatively inexperienced to handle regulatory matters, particularly in the area of on-site inspections. He resigned at the time of the visit and has no obvious successor within the VFSC.

130. The Insurance Act does not adequately address the fit-and-proper criteria and enforcement powers, and there are a number of exemptions for offshore insurance companies that further weaken the regulation of this sector. Part V specifically exempts offshore insurers from certain key provisions, most notably:

- Minimum capital requirements (Section 4);
- The fit-and-proper test for persons associated with the insurer (Section 6);
- Audit requirements (Section 16);
- Separate account requirement for insurance companies (Sections 13 and 14); and

- Periodical investigation requirements into life companies (Section 20).

Recommendations

131. If Vanuatu is going to support the regulatory process, it must focus resources in key areas. There needs to be consolidation of offshore and domestic insurance under one adequately resourced and experienced body that has operational independence, free from political involvement. Additionally, thought should be given either to consolidating insurance supervision with banking supervision (see the discussion in section II) or to the design of a formal communication structure between the two regulatory agencies.

132. It is recommended that a detailed procedures manual be developed to facilitate ongoing supervision. The sudden resignation of the insurance supervisor, without a successor, highlights the need for documented procedures in order to ensure continuity and to provide transparency of process. The manual should cover such areas as licensing, due diligence, enforcement actions, and on-site supervision.

133. It is recommended that a full review of the Insurance Act be undertaken to examine the recommendations within this report, focusing on operational independence, sanctions, fit-and-proper tests and financial reporting. At the same time, the Act should be amended to allow for the power to appeal any regulatory decision. The absence of such is contrary to natural justice, and it is recommended that a structure for appeals be introduced as soon as possible.

134. It is also recommended that the insurance supervisor hold meetings with licensees on a regular basis. This process is to be encouraged as another method of gauging an understanding of a licensee's business development, and of facilitating routine communication between the regulator and the licensee.

Licensing (Principle 2)

135. Under Section 6 of the Insurance Act, the minister of finance is prohibited from issuing a license if it appears that it would be contrary to the public interest. The minister may also refuse a license for a domestic insurer if any officer is not fit and proper to be associated with insurance companies.

136. However, the fit-and-proper test is not defined, only extends to domestic insurers, and only extends to officers of the licensee. It was explained to the mission that, in practice, due diligence is performed and certain documents were obtained from key functionaries including a biographical affidavit; passport photograph; police clearance certificate; statement of net assets and liabilities; and two references. It was stated that those giving the references were also contacted and the services of the International Chamber of Commerce in the United Kingdom were utilized for carrying out certain checks.

137. However, it was the impression of the mission, that this process is not consistently applied in all cases and, in any event, lacks full statutory support. It is evident that there are inconsistencies in the licensing process caused by a lack of training and a shortage of staff.

138. In discussing the structure of license applications, the mission noted a number of material problems. The business plans were incomplete, as they lacked pertinent information on which to make a full judgment, particularly in the areas of anti-money laundering and complexity of the business, and there was no evidence of relevant communication with overseas authorities.

Recommendations

139. The VFSC needs to clarify further the attributes of fit and proper, which are generally accepted to include honesty, integrity, competence, capability, and financial soundness. It could be argued that this is implied under Section 6 of the Insurance Act, where the minister may refuse an application that is against the public interest, but this is too broad and it is common practice to define explicitly the requirements for key functionaries. The Insurance Act should provide for rules that define the necessary forms for completion by key functionaries, as well as the application forms themselves.

140. It would be appropriate to issue a guidance note in relation to the fit-and-proper test, clarifying the approach to the following:

- Offences—the significance of any offence known to the supervisor is considered on its merits, taking full account of all available information concerning the surrounding circumstances;
- Bankruptcies—where an individual has been involved in a bankruptcy, account is taken of the surrounding circumstances, particularly the nature of the individual's role and degree of culpability;
- Experience—in considering the proposed appointments of directors, it is expected such people should have had 5 years' experience in the preceding 10 years at a similar level or, for more junior positions, experience in a licensed insurance company that has carried on similar business.

141. It is recommended that a procedures manual be constructed and implemented together with a fitness checklist, containing all possible checks, instituted for all key functionaries. From these licensing procedures, guidance notes can be developed and consistency can be achieved in the licensing process.

142. Guidance notes would also be useful for offshore insurance, for example, where a detailed explanation of the requirements of the business plan could be provided as a clarification of Section 5 of the Insurance Act. The business plan should cover, as a minimum, the first three years of the company's operations, and should address coverage; exposures; reinsurance; capitalization; fronting arrangements; loss control; underwriting; claims management; corporate governance; ownership; and any other pertinent information. New plans should be filed with the VFSC whenever a change to the content takes place. This is particularly critical for the offshore insurance sector.

Change in control (Principle 3)

143. Section 11 of the Insurance Act requires that a registered insurer notify the VFSC of any new principals, a change of principal office, or a change in name of the principals within 20 days of the change. Section 21, which does not apply to offshore insurance companies, provides that no local insurance company may amalgamate or transfer its insurance business unless the transfer is sanctioned by the minister.

144. However, the provisions of Section 11 are for notification only and do not require prior sanctioning by the insurance supervisor and, furthermore, do not relate to beneficial or ultimate ownership.

Recommendation

145. The VFSC must be in a position to review changes in the control of companies that are licensed in Vanuatu. It is recommended that the Insurance Act be amended to grant the VFSC the power to approve changes in beneficial ownership, and to establish clear requirements to be met when a change in control occurs. This should be extended to all licensees and not just local insurance companies. These requirements should be identical to the requirements outlined in the recommendations for Licensing (Principle 2).

146. The requirements for beneficial ownership should be outlined and changes should, at a minimum, necessitate the submission of two years of annual reports for corporate bodies, or, in the case of natural persons, two references, copies of passports; CVs; qualifications of the principals; a police clearance report; and statements of shareholders' assets and liabilities.

Financial reporting (Principle 12)

147. The financial reports submitted to the VFSC are limited in the information that they provide, and little analysis of the data is performed by the VFSC. A strong reporting environment is critical in Vanuatu, because it is presently the sole method for ongoing supervision of licensees. An additional advantage is the availability of statistical data on the insurance market, which would be useful to prospective licensees as well as existing licensees.

148. The accounts of a domestic insurance company are required to be filed annually under Section 16 of the Insurance Act. The accounts and supporting documents must be signed by the directors of the company, who are ultimately responsible for their accuracy. Accounts must be audited by an independent auditor and properly prepared in accordance with sound insurance principles.

149. The VFSC has the power under Section 16(3) to require a domestic insurance company to furnish such further particulars as may be prescribed in the rules. Section 20 requires companies writing long-term business to provide an actuarial valuation report of its liabilities every three years.

150. Section 17(1) requires that a domestic insurance company provide within six months of year-end, a certified copy of the audited balance sheet and accounts showing the financial position of all insurance business and any such documents and information as prescribed by rules. Section 17(2) requires a copy of any report on the affairs of the domestic insurance company submitted to policyholders or shareholders. Section 17(3) requires these statements to be made public.

151. Offshore insurance companies are exempt from the provisions of Section 16, 17, and 20. However, they are required to file audited financial statements on a consolidated basis or solo basis under Section 377 of the Companies Act. The accounts must be signed by the directors of the company, who are ultimately responsible for their accuracy. The supervisor has powers to require the correction of any inaccuracies in the financial statements.

152. Section 37 of the Insurance Act grants the VFSC the power to require an insurer to furnish it, at specified times or intervals, with information about specified matters being, if it so requires, information verified in a specified manner. However, there was no evidence presented that this power has been used in the context of financial reporting.

Recommendations

153. The Insurance Act should be amended to remove the exemption on statutory filing requirement for offshore insurance companies, and to clarify the documentation required in support of the audited financial statements. As a minimum, the required filing forms should be outlined in rules issued by the VFSC.

154. It is recommended that valuation reports be consistently requested and analyzed for long-term business. Furthermore, the power to request, but not necessarily require, a valuation report should be extended to all classes of business, particularly where the calculation of IBNR (incurred but not reported) is required.

155. It is recommended that the checklist be produced to provide a summary of exposures on an expected-loss basis, a worst-case basis and also on a total-loss basis, all compared to the funds available over the forthcoming year. Efforts should then be made to explain all observations, particularly with reference to the adequacy of the reinsurance program, the level of long-term business reserves, an analysis of underwriting lines, and the strength of the parent where Vanuatu is not the home supervisor.

156. It is also recommended the financial results be accessible on a system at the lowest denominator, which would be a profit-and-loss statement by class of business. This would be useful in providing industry-specific data for statistical purposes, as well as assisting the supervisor in identifying trends.

157. It is recommended that fines be imposed for late filings with additional interest for each month that the fine is unpaid. Where serious violations occur, an additional penalty of license suspension can be imposed.

158. A comprehensive procedures manual should be developed relating to financial analysis. This really follows basic underwriting principles. It is important that the industry be made aware of the methods used by the VFSC.

On-site inspections (Principle 13)

159. The system of supervision is based solely on the filing of audited accounts and of a directors' report. There is no practice of performing on-site inspections.

160. Section 39 of the Insurance Act allows for the application of on-site inspections, but this process has never been implemented. Full on-site inspections represent an invaluable asset in the prudential supervision of insurers and insurance intermediaries, and also permit a review of corporate governance, internal controls, and anti-money-laundering procedures.

161. Section 39 of the Insurance Act does not appear to allow the outsourcing of on-site inspections.

Recommendations

162. A fully documented and structured on-site program should be developed. In the event of a statutory violation, there is no evidence at present that a structured investigation could efficiently take place. The RBV has in place an inspection program, and should insurance regulation be transferred to this entity, the insurance regulator would benefit from the existing resources available for training and implementation. Since section 39 of the Insurance Act does not appear to allow the outsourcing of on-site inspections (for example, to external accountants), consideration should be given to repealing this section. Given the lack of qualified resources available in the VFSC with on-site inspection experience, outsourcing may be the simplest solution to resolving the problem.

163. At a minimum, the inspection manual should take into account an examination of anti-money-laundering procedures; compliance issues; internal controls; underwriting and claim practices; reinsurance; accounting systems; and corporate governance, as well as the more obvious areas such as capital adequacy and investment management. The Offshore Group of Insurance Supervisors ("OGIS") has produced a template on-site supervision manual, and this could be obtained as a starting point for Vanuatu to develop a suitable program.

Sanctions (Principle 14)

164. There is a very limited range of powers available under Section 9 of the Insurance Act, which permits the minister of finance to cancel the insurance license only in the following circumstances:

- the licensee has ceased or not commenced carrying on business;
- the minister is not satisfied that there are sufficient free assets for the safe conduct of business;

- insurance business is not being conducted in accordance with sound insurance principles;
- the licensee has gone into voluntary liquidation;
- the license was procured from false, misleading, or inaccurate information;
- in the case of a company that carries on some form of business in addition to insurance business, that business is likely to be contrary to the public interest; and
- the licensee has contravened any provision of the Insurance Act, e.g., late filing of statutory returns.

165. It should be noted that the first three points only apply to domestic insurance companies. Section 52 provides for imprisonment and fines for gross contraventions of the Act. No decisions made by the minister of finance can be appealed in any way. In fact, Section 53 specifically defines “decisions not to be questioned in court” by stating that no decision made by the minister or registrar shall be called into question in any court, in any proceedings, whatsoever.

166. The intervention powers are equally limited as follows:

- the minister may set restrictions on investments for domestic insurance companies;
- the minister may limit or prohibit a domestic insurer from writing new policies;
- the minister may appoint inspectors to investigate the affairs of an insurer; and
- the VFSC may demand such information as it may specify.

Recommendations

167. In terms of sanctions, it is recommended that the VFSC has a more flexible range of powers to facilitate efficient handling of problem cases. These might include powers:

- to force a portfolio transfer or commutation of business;
- to effect a cease-and-desist order when a licensee is carrying business that is unsafe or unsound;
- to remove external auditors or appoint a special auditor at the expense of the licensee;
- to remove external actuaries or appoint a special actuary at the expense of the licensee;
- to remove directors, officers, or key personnel for not being fit and proper or for conducting business in an unsound manner;
- to immediately suspend a license pending an investigation; and
- to impose administrative fines on a licensee without summary conviction.

168. These powers should be vested in the VFSC and not the minister of finance, and should be applicable to all licensees and not just domestic insurance companies.

169. In line with the principles of natural justice, any licensee should have the statutory right to appeal any decision made under the Insurance Act. The provisions under Section 53 of the Insurance Act should be removed.

Cooperation and coordination (Principle 16)

170. In order to share relevant information with other insurance supervisors, adequate and effective communication should be developed and maintained. In developing or implementing a regulatory framework, consideration should be given to whether the VFSC is able to enter into an agreement or understanding with any other supervisor, both in other jurisdictions and in other sectors of the finance industry, to share information or otherwise work together. This may be limited to supervisors who have agreed, and are legally able, to treat the information as confidential. Any such agreement should set out the types of information involved and the basis on which information obtained by the insurance supervisor may be shared.

171. Section 381(3) of the Companies Act provides that a liquidator appointed by the court may, upon request in writing of a public officer in any country or territory and with the consent of the attorney general, disclose to such public officer information with respect to the affairs of an offshore insurance company. However, formal “gateway” provisions do not exist in the Insurance Act and are not explicitly clear in the Companies Act.

Recommendations

172. While cooperation does in practice take place on an informal basis, it is unclear as to what information can be shared or if there are limitations. This applies not only to cross-border cooperation, but also internally with respect to cooperation between the VFSC and the RBV. It is recommended that formal “gateway” provisions be developed and implemented, and that consideration be given to formulating a model memorandum of understanding (MOU) that would define the arrangements for regulatory exchanges.

173. There is currently no formal mechanism to ensure that another body responsible for investigating fraud or money laundering will inform the VFSC about an investigation that is taking place of an insurer licensed and supervised by the VFSC. In particular, it is possible that they will be unaware of the number or type of disclosures to the FIU that could have some bearing on prudential supervision, although, under the FTRA, the FIU has the power to forward STRs to the VFSC, if the attorney general deems it appropriate. The authorities have stated that it has always been government policy that any department or agency that may be affected by a particular action or decision must be informed, and they believe that this has always been the case with respect to any investigations into a licensed insurer. The VFSC has assisted other authorities in the past and is continuing to do so in money laundering and fraud investigations involving companies or individuals, and also assists in conducting due diligence on behalf of other authorities. However, the mission recommends that there should be routine scheduled meetings between the VFSC and the FIU to build on this relationship.

VIII. ASSESSMENT OF THE TRUST COMPANY SECTOR

A. Introduction

174. There is no international grouping for trust and company service regulators, and there are no international standards concerning the regulation and supervision of trust and company service providers.⁵

175. However, since the business of trust and company administration is a significant feature of the offshore market in Vanuatu, it is appropriate to make some judgment about the adequacy of the legislation, regulation, and supervision of these activities. Companies providing these services generally act as the point of entry for outsiders to the local offshore market, and, therefore, their standards of probity and conduct of business can greatly influence the level of risk (particularly reputation) within the market.

176. Recently, two well-publicized reviews of certain offshore financial centers have been conducted. Each review included a substantive assessment of trust and company service providers.⁶ In both reports, some broad general principles were applied, explicitly and implicitly, as guides to what can be considered good practices. These principles bear a significant resemblance to regulatory principles established by international bodies in relation to the supervision of banking, investments, and insurance.

Structure of the sector

177. Ten entities are licensed to conduct trust business in Vanuatu, although only 8 service international clients. Of these eight, three are international accounting firms, two are legal firms, and three are dedicated trust and company service providers. All license holders have a physical presence in Vanuatu.

178. As there is no requirement to register trusts in Vanuatu (other than Authorized Unit Trust Schemes under the Prevention of Fraud (Investments) Act), there is no record of the total number of trusts established, nor of the value of property in trust. However, from general enquiries, it is possible to state that trusts are not widely used in Vanuatu.

⁵ In September 2002, subsequent to the assessment mission, the Offshore Group of Banking Supervisors agreed to a statement for best practice with respect to the regulation of trust and company service providers. In general, the discussion in sections VI and VII of this report is compatible with the OGBS statement.

⁶ Review of Financial Regulation in the Crown Dependencies in November 1998 and the KPMG Review of Financial Regulation in the Caribbean Overseas Territories and Bermuda in October 2000.

Legal framework

Trust service providers

179. The Trust Companies Act, which was brought into force on May 13, 1971, regulates the provision of trust business, which is defined as the business of acting as trustee, executor, or administrator. Under the Act, it is an offence to conduct trust business without a license. The Act also restricts the use of the words “trust company” and similar words by companies.

180. Other activities, such as trust formation, and the provision of nominee services are not regulated.

181. A person carrying on business as a trustee “in respect of funds of other persons” is defined as a financial institution under the FTRA and is required to verify customer identity (where the amount of a transaction exceeds Vt 1 million). No guidance is produced on the verification of identity of trusts. Nor has any external agency confirmed that trustees adhere to these requirements.

Trusts

182. No modern trusts legislation is in place. The United Kingdom’s Trustee Act of 1925 (as in force and, subsequently, amended up to the time of Vanuatu’s independence in 1980), the substance of English Common Law, and doctrines of equity, all provide the basis for the principles that govern the law of trust in Vanuatu. The Supreme Court of the Republic of Vanuatu (Supreme Court) may also take into account any subsequent changes to the 1925 Act, and follow case law in England and other commonwealth jurisdictions as persuasive legal authority.

183. There are the same types of trusts in Vanuatu as there are in the United Kingdom, i.e., discretionary trusts; interest in possession trusts; accumulation and maintenance trusts; and charitable trusts.

Regulatory framework

184. The Trust Companies Act sets out the basis for licensing applicants under the Act, including the consideration of fitness and propriety, and provides the minister of finance and economic management with a number of powers and sanctions. It also provides for the appointment of an inspector of trust companies to monitor the activities of trust companies in Vanuatu.

185. Parts I and II of the Schedule to the Act set out a number of requirements that must be taken into consideration when an application for a license is being considered. Among other things, an applicant is required to submit a three-year business plan; evidence in writing that the governing body of the trust company itself, or some person or company directly or indirectly connected with or interested in such a trust company, is possessed of substantial and practical experience in trust company business; evidence of a prescribed capital base (Vt 12.5 million or

Vt 50 million, depending on the company's structure); character references in writing for each director or officer (together with such evidence as may be required that none has a criminal record); the name, address, and nationality of each shareholder; and annual accounts for the holding or parent company (if any). It is not an offence to provide false and misleading information in an application.

186. While each application for a license is to be made to the minister, the VFSC first considers the application itself, and assesses the criteria prescribed in the Trust Companies Act. On the basis of this assessment, the VFSC recommends to the minister whether he should grant or refuse an application. In considering an application, the minister, who is also guided by the attorney general, is bound only to consider whether the carrying on of the proposed business will "not be against the public interest." The minister may grant a license subject to such terms and conditions as may be deemed necessary. Whenever he considers it to be in the public interest, the minister may refuse to grant a license and need not give any reason for so refusing.

187. Once a license has been granted, the minister must approve any proposed change in ownership in advance. There is no requirement under the Trust Companies Act to notify changes in directors, except in circumstances where the head or registered office is outside Vanuatu and the director is the officer designated under the Act (although changes in directors will be reported on an annual basis under the Companies Act).

188. The minister is able to revoke a license, issue directions, and order that a business be wound up where, among other things, he considers that a business is being run in a manner that is detrimental to the public's interest, or the interests of creditors or customers. He is also able to require the provision of financial statements and "such other information relating to the licensee as may be so specified," and to appoint an inspector of trust companies to maintain a general review of the activities of trust companies in Vanuatu, and to examine the affairs of each licensee to ensure that it is in a sound financial position. No inspector has been appointed under the Act, and there is no ongoing supervision of trust company service providers (other than the submission of audited financial statements under the Companies Act). Nor is there any supplementary legislation or guidance in place addressing the segregation of customer assets, span of control, or other sound principles for the conduct of business.

189. Under the Act, information collected may be released only with the agreement of the trust company concerned.

B. Good Practice Issues

190. There are no international standards concerning the regulation of trust service providers. However, some broad principles that are listed below are being more widely accepted and are among those that have been used by some authorities in assessing good practices. The identifying numbers are used for ease of reference only and do not relate to any accepted methodology or set of standards.

GPI: Only fit-and-proper persons should be able to offer trust services. Appropriate sanctions should be available to the regulator to deal with those that are not licensed, or do not act in a fit-and-proper manner. The regulator should have effective and independent enforcement powers, including the power to monitor and supervise licensed trust service providers, to inspect their activities, and to investigate potential breaches of rules, regulations, and laws.

Comment

191. Some areas of trust services are outside the current definition of “trust business,” e.g., arranging for another person to act as trustee.

Recommendation

192. The current definition of trust business should be expanded to ensure that it extends to all areas of trust business undertaken.

Comment

193. Applications to conduct “trust business” (as defined in the Trust Companies Act) are granted or refused by the minister, who is required to ensure that the carrying on of trust business is not against the public interest, rather than that the provider is fit and proper. While an assessment of fitness and propriety may form part of an assessment of the public’s interest, “public interest” is capable of being interpreted in much wider terms. It is not an offence to provide false and misleading information as part of an application to be licensed as a trust company.

194. The minister is required to consider and approve all changes in the beneficial ownership of a licensee.

Recommendations

195. Applications should be considered and assessed by the regulator rather than the minister. It should be a criminal offence to provide false and misleading information to the regulator, and subject to an unlimited fine, imprisonment, or both.

196. The current assessment of fitness and propriety at the time of application should be extended and have a statutory basis. It should include an assessment of “span of control” (at least two individuals controlling the business), structure, organization, and physical presence in the country. A detailed standard application form, which should be published, should be used by every applicant.

197. This application form might be expected to ask (among other things) for the name of the compliance officer and money-laundering reporting officer; details on insurance cover; the name of the applicant’s auditor; the extent of the applicant’s existing activities; disclosure of whether or not the applicant is regulated in another jurisdiction, or has previously applied to regulatory

authorities in other jurisdictions; disclosure of whether the applicant has ever had a license or membership of another body revoked, or been criticized, censured, or disciplined; and disclosure of any past financial difficulties. The form might require detailed personal questionnaires to be submitted for all directors and owners.

198. The regulator should be entitled to object to any changes in ownership and directors, and should be notified in advance. It should be an offence to fail to notify the regulator of any change. It should also be open to the regulator, in case of need, to bar individual officers or key personnel from taking part in the provision of the trust service provider's activities.

Comment

199. While legislation provides for the minister and an inspector of trust companies to review the affairs of a license holder, to date, this enforcement power has not been used. In any event, it is not clear whether or not the inspector's powers would extend beyond "general" reviews, and an assessment of the financial solvency of each licensee, and whether legislation would routinely permit records of underlying customers to also be reviewed.

200. Ongoing supervision of activities is limited to the provision of audited financial statements that must be delivered under the Companies Act within eight months of the end of the accounting period (subject to an extension of a further period of four months). Only an auditor that is authorized by the minister may act as auditor to an exempt company, although it is not necessary to demonstrate any particular relevant experience to audit a trust company.

Recommendations

201. The regulator should exercise all responsibilities currently held by the minister, and intended for the inspector of trust companies under the Trust Companies Act, which provide for a power to require the provision of information and documents, to instigate investigations, and to enter and search premises. These powers should be used to ensure that trust service providers comply on a continuing basis with fit-and-proper tests and codes governing expected standards of conduct and diligence (see below). While there are no international standards governing the frequency of visits, an on-site inspection program should cover all service providers at least once every three years.

202. Legislation should also provide for the submission of annual audited financial statements by an approved firm of auditors within four months of the year-end, external certification of compliance with regulatory standards, the segregation of client assets, and restrictions on undesirable or misleading advertising. Auditors should be provided with a gateway through which to report anything relevant to the regulator's functions.

203. Provision should be made for codes governing the standards of conduct and diligence expected from trust service providers, and the regulator should have the power and duty to disqualify providers failing to discharge their activities adequately in terms of the codes. Codes should oblige providers to conduct business with integrity; to have the highest regard for the interests of customers; to organize and control their affairs effectively for the proper performance

of business activities, and to be able to demonstrate the existence of adequate risk management systems; to be transparent in business arrangements; to maintain and be able to demonstrate the existence of both adequate financial resources and adequate insurance; and to deal with the regulator and other authorities in an open and cooperative manner. Specifically, codes should address compliance with anti-money-laundering legislation and guidance, ensuring that employees hold relevant qualification and experience (which should be prescribed), and establishing a dedicated resource to ensure compliance with legislation and to monitor operational performance.

204. The regulator should have a clear and unambiguous statutory basis for reviewing underlying customer files to test whether a service provider is compliant with legislation and codes, and to obtain information to assist in regulatory investigations.

205. It should also be an offence to knowingly or recklessly make false statements or provide false and misleading information to the regulator, and to obstruct the regulator during a statutory investigation.

Comment

206. In addition to requesting information from license holders (including financial statements), the minister is also able to revoke a license, issue a direction, and make an order requiring the licensee to be wound up. The minister is not able to set additional conditions on a licensee, to issue a public statement, or to fine.

Recommendations

207. In addition to sanctions currently available to the minister, the regulator should be able to amend and set additional conditions on a license, issue public statements (to “name and shame”), and to fine. An appeals procedure would also be needed as a counterbalance to such powers. The regulator should also make maximum use of civil law procedures, not least for calling in persons to manage or wind up businesses, and for restraint and recovery of assets.

GP2: The regulator should have the power to cooperate with domestic and international agencies that share similar supervisory responsibilities. This should include a power to spontaneously provide information, and to collect information to assist another regulator.

Comment

208. There are no statutory gateways through which information held on trust service providers may be passed. Indeed, under the Trust Companies Act, information collected may be released only with the agreement of the trust company concerned.

Recommendation

209. Information collected by the regulator in the exercise of its functions should be confidential, but there should be a statutory gateway through which to exchange information

held. This gateway should include powers to cooperate with other supervisory authorities (domestically and internationally). It should also provide for certain information on trust service providers to be disclosed to the general public (e.g., class of license held).

GP3: At any time, a country's authorities should have a means of establishing the settlors, protectors, and beneficiaries of trusts that are settled in their jurisdiction.

Comment

210. Guidelines for financial institutions issued by the Financial Intelligence Unit of the State Law Office do not clearly establish whom a trustee is expected to identify in order to conform to the requirement to verify a customer's identity under the FTRA. Nor does that legislation extend to the act of arranging for another person to act as trustee. Accordingly, insufficient information may be held in Vanuatu on a trust.

Recommendation

211. Legislation (regulatory or anti-money laundering) should require trust service providers to hold up-to-date information on the settlors, protectors, and beneficiaries of all trusts for which they act. The regulator should monitor compliance with this ongoing requirement, regularly reviewing underlying customer records to ensure that information is held. There should be severe criminal penalties in place to deal with those that do not hold this information.

GP4: Trusts should not be used to obscure the true ownership of assets, frustrate legitimate claims, or defraud creditors.

Comment

212. Trusts may be used to conceal assets from creditors, estranged spouses, suitors, and tax authorities, and they may be used in the elaborate processes of concealing the proceeds of crime from police, customs, prosecutors, and courts. Trusts may also be used to try to put assets, even if discovered, beyond the reach of pursuers.

213. Settlers may seek an arrangement whereby the trustee recognizes that the assets remain the settlor's in all but name and that the task of the trustee is to do exactly what the settlor says.

Recommendations

214. Under Codes governing the standards of conduct and diligence expected from trust service providers, providers should be able to demonstrate that reasonable care has been taken to understand and verify the purpose of a trust, and to ensure that it is legitimate and effective. Trust service providers should also take reasonable steps to ensure that legal and taxation obligations are understood.

215. The regulator should have the power and duty to disqualify trust service providers, and staff members concerned, where they fail to act in accordance with these standards.

GP5: At any time, a country's authorities should have a means of access to basic financial information relevant to the activities of trusts. Trust service providers should be obliged to make proper disclosure to beneficiaries, any co-trustees and any protectors, and to produce, submit, and preserve accounts.

Comment

216. There is a range of abuses that could possibly arise as a result of unscrupulous behavior by the settlor, the trustee, or both. The risk of such abuse can be reduced if the conduct and the administration of the trust can be monitored. Professional trustees, by the nature of their duties and responsibilities, must be accountable for their actions, particularly if negligence or default is willful.

217. Beneficiaries have a right to expect a trust service provider to administer the trust with care, prudence, and probity. Similarly, the prime beneficiaries, the co-trustees, and any protector should be entitled to call on the trustee for the production of accounts in order to review the stewardship of the trust, to ensure that it is being properly administered, and the terms of the trust adhered to. Such reporting, on a periodic basis, should act as a deterrent and reduce the risk of misappropriation of the trust funds by unscrupulous trustees.

Recommendation

218. Trust service providers should produce, submit, and preserve accounts as appropriate.

GP6: Trust service providers should have effective anti-money-laundering measures in place, including know-your-customer rules, record keeping, staff training, and reporting procedures. Providers should be obliged to establish the identity of the "customer" to which they provide services.

Comment

219. Under the FTRA, trustees are required to identify customers (where the amount of a transaction exceeds Vt 1 million) and to report suspicious transactions to the FIU. They are also subject to record keeping and staff training requirements. Other trust service providers, e.g., those forming trusts, are not subject to the Act's requirements.

220. No external agency has confirmed adherence to these requirements. Nor is guidance available to define "customer" in relation to a trust.

Recommendation

221. All service providers (including those forming trusts) should be required by statute to obtain and verify information on settlors, protectors, and beneficiaries, to keep records, to train staff, and to report suspicious transactions to the FIU.

IX. ASSESSMENT OF THE COMPANY SERVICE PROVIDER SECTOR

A. Introduction

Structure of the sector

222. A number of accountants, lawyers, and dedicated service providers are active in this sector, providing company formation, secretarial, management, administration, and nominee services.

223. No official information is available on the size of this sector, as the provision of corporate services to Vanuatu and foreign incorporated companies is not subject to any licensing or supervisory requirement. However, the number of companies registered is likely to provide a useful indication of activity.

224. As of March 31, 2002, there were 1,323 local companies, 174 exempt companies, and 4,342 international companies registered with the Registrar of Companies (which is subsumed within the VFSC). In the period from January 1, 1999 to March 31, 2002, 19 exempt companies and 2,948 international companies were registered, and 823 companies (local, exempt, and international) struck off. Relative to the size of other offshore financial centers, Vanuatu's corporate registry is small. The service providers also act in respect of an unknown number of foreign-incorporated offshore companies.

225. Until 1992, when the International Companies Act was introduced, exempt companies (as opposed to local companies) incorporated under the Companies Act were typically used by nonresidents. However, use of such companies was limited, since, despite the exemptions given, the overall company law requirements were considered to be more onerous than in many other jurisdictions. In contrast, incorporation and ongoing requirements under the International Companies Act are minimal, and the law requires only the name of the company, its registered office, and the name and address of its registered agent to be held in the country. In 2001, just 5 exempt companies were formed against 557 international companies.

226. While no information is held on the main geographical markets for international companies, nor on their activities, it is apparent that their uses are similar to those of companies registered in other offshore jurisdictions (predominantly, asset and private investment holdings), and that ownership is largely nonresident; generally, individuals based in Asia, Australia, and New Zealand.

Legal framework

Company service providers

227. There is no legislation in place addressing the regulation of company service providers.

228. Company service providers (other than those “administering or managing funds”) are not subject to the anti-money-laundering requirements of the FTRA.

Companies

229. Local and exempt companies are formed under the Companies Act (last updated in 2000), which is based on United Kingdom legislation of 1967. International companies are formed under the International Companies Act (also updated in 2000). In general terms, exempt and international companies are prohibited from carrying on business in Vanuatu, and cannot invite the public (anywhere) to subscribe for shares or debentures. In addition, international companies cannot carry on banking, trust company, insurance, or company management business.

230. Every company must have a registered office in Vanuatu. In addition, every international company must also have a registered agent in the country.

231. The VFSC processes all applications for exempt company registrations, which are passed, with a recommendation to grant or refuse, to the minister (who is also assisted by the attorney general). Where an application is granted, then the Registrar registers the company. The VFSC alone is responsible for the registration of international companies.

232. Some due diligence is conducted on applications to form exempt companies, the majority of which will carry on banking, trust company, insurance, or company management business. Applicants must provide details on intended directors and business activity. In practice, information on beneficial ownership is also requested (though it is not a legal requirement to do so in all cases). Intended directors and beneficial owners are also expected to provide copies of passports, and data checks are conducted with authorities in (but not exclusively) Australia, New Zealand, and the United Kingdom. The minister may, in his discretion, grant or refuse an application, and need not give any reason for his decision. There are no notification requirements for subsequent changes in beneficial ownership or activities (though these might be apparent from the financial statements, and the minister does have the power to request information on beneficial ownership subsequent to registration).

233. In contrast, any person wishing to register an international company (which accounts for the vast majority of registrations) needs to file only a “constitution” with the VFSC, though registration may be refused if insufficient information is provided. No declaration of intended beneficial ownership or activity is required. The constitution is required to identify the company’s registered office and agent.

234. Exempt companies are required to provide an annual return to the Registrar, listing shareholders and directors, and to file annual audited financial statements (with some

exemptions). There are no ongoing reporting requirements for international companies, other than to advise any change in registered office or agent.

235. Every overseas company wishing to establish a place of business within Vanuatu must also register with the Registrar and file accounts (though this does not extend to those overseas companies that are administered in the country).

236. As a result of secrecy provisions in the Companies Act, information held by the VFSC on exempt companies is not available to the public. Nor may the names of registered shareholders or directors be obtained from an exempt company's registered office. However, confidential information held by the VFSC can be disclosed outside of the country on the production of a court order, where permitted under other legislation, and, in certain circumstances, on its liquidation.

237. While the public does have access to the information that is held by the VFSC on international companies (which is very limited), secrecy provisions in the International Companies Act make it an offence for any person to disclose information concerning ownership and management, except where required to do so by court order, or "for the carrying on of the business of the company."

238. Certain exempt companies and all international companies may issue bearer shares.

239. The Companies Act and International Companies Act require every officer of a company, in performing his functions, to act in good faith and in the best interests of the company, and to exercise care, diligence, and skill, although, under the International Companies Act, there is no provision to disqualify those that do not. Corporate directors are permitted under the International Companies Act.

240. The minister may appoint inspectors to investigate the activities of an exempt company where there are grounds to believe that it is involved in a fraudulent or unlawful purpose. A power is also available to the Supreme Court under the International Companies Act to investigate the affairs of a company where there is reasonable cause to believe that one of its officers has committed an offence in relation to its management.

Regulatory framework

241. Company service providers are not regulated. While there are no legal restrictions on who may form a Vanuatu company, in practice, the VFSC expects applications to incorporate exempt and international companies to be submitted by an accountant or lawyer practicing in the country, licensed trust companies, or experienced company service providers.

B. Good Practice Issues

242. There are no international standards concerning the regulation of company service providers. However, some broad principles that are listed below are being more widely accepted and are among those that have been used by some authorities in assessing good practices. The identifying numbers are used for ease of reference only and do not relate to any accepted methodology or set of standards.

GP1: Only fit-and-proper persons should be able to offer company services. Appropriate sanctions should be available to the regulator to deal with those that are not licensed, or do not act in a fit-and-proper manner. The regulator should have effective and independent

enforcement powers, including the power to monitor and supervise licensed company service providers, to inspect their activities, and to investigate potential breaches of rules, regulations, and laws.

Comment

243. *The provision of corporate services to Vanuatu and foreign incorporated companies is not subject to any licensing or supervisory requirement.*

Recommendation

244. In view of the importance of this sector to the integrity of the offshore industry, in general in Vanuatu, it is preferable that company service providers should be licensed by the regulator and subject to a full supervisory regime. An outline of the principles for such a regime is provided in Box 1 at the end of this section. The initial registration process should set high standards to weed out dubious or incompetent providers, as it is far easier not to register in the first place than to remove a registration previously given.

245. All areas should be included within the scope of legislation (where carried on as a business), including the formation of companies; acting as or arranging for another person to act as a director, alternate director, partner, secretary, alternate, deputy secretary, or agent of a company; providing a registered accommodation, correspondence, or administrative address; and acting or arranging for another to act as a shareholder or unit holder as a nominee for another person. The law should also provide for the ability to provide for exemptions.

GP2: The regulator should have the power to cooperate with domestic and international agencies that share similar supervisory responsibilities. This should include a power to spontaneously provide information and to collect information to assist another regulator.

Comment

246. The provision of corporate services to Vanuatu and foreign incorporated companies is not subject to any licensing or supervisory requirement. While the Companies Act and International

Companies Act both provide for the collection of information in certain circumstances, there are no statutory gateways through which it may be passed.

Recommendation

247. Information collected by the regulator in the exercise of its functions should be confidential, but there should be a statutory gateway through which to exchange information held. This gateway should include powers to cooperate with other supervisory authorities (domestically and internationally). It should also provide for certain information on company service providers to be disclosed to the general public (e.g., class of license held).

GP3: At any time, a country's authorities should have a means of establishing the ultimate beneficial owners, directors, and activities of companies that are incorporated in their jurisdiction, and foreign incorporated companies administered therefrom.

Comment

248. Company service providers are not required to hold information on the directors, beneficial shareholders, or activities of exempt and international companies incorporated (or continued) in Vanuatu, or foreign incorporated companies that are administered in Vanuatu.

249. While the VFSC holds this information at the time of registration of exempt companies, subsequent changes need not be notified (though directors will be reported as part of an annual return to the Registrar). In the absence of any regulation, company structures can be abused to conceal and disguise disreputable purposes.

250. Exempt and international companies may issue bearer shares. While there may be legitimate reasons for their use, these instruments are often abused and enable the unscrupulous to conceal their ownership of companies.

Recommendations

251. Legislation (regulatory or anti-money laundering) should require company service providers to hold up-to-date information on the beneficial ownership, directors, and activities of all companies for which they act. The regulator should monitor compliance with this ongoing requirement, regularly reviewing underlying customer records to ensure that information is held. There should be severe criminal penalties in place to deal with those that do not hold this information.

252. Company service providers should report subsequent changes in ownership, directors, and activities of exempt companies, to the VFSC.

253. In line with developments in other jurisdictions that permit bearer shares, e.g., the Cayman Islands, the authorities may wish to require that company service providers should be satisfied that effective custody or immobilization arrangements are in place to ensure that any change in ownership may be controlled and monitored.

GP4: The use of companies in sensitive activities that risk bringing the center into disrepute should be avoided.

Comment

254. The VFSC has not published a list of sensitive activities (e.g., pornography or arms dealing) for which approval to register an exempt company will be withheld, and which company service providers should avoid.

Recommendation

255. The VFSC should publish a list of sensitive activities. Service providers should have due regard for activities listed.

GP5: At any time, a country's authorities should have a means of access to basic financial information relevant to the activities of companies. Without this, the nature, scale and purpose of the activities of individual companies are not likely to be known, and the greater the risk of abuse must be.

Comment

256. Exempt and international companies are required to maintain accounts and records, but there are no requirements to audit or to disclose any financial information held.

Recommendation

257. Service providers should ensure that accounts and records are maintained in line with company law requirements (financial statements in the case of certain exempt companies). Where a Vanuatu service provider does not maintain these accounts and records, they should be requested and reviewed on a periodic basis.

GP6: Authorities should be aware of the extent to which foreign incorporated companies are administered or otherwise operating in a jurisdiction, since there are risks in hosting business about which they have no knowledge.

Comment

258. The Companies Act provides for the registration of companies incorporated outside Vanuatu (overseas companies), where they establish a place of business in Vanuatu. Foreign incorporated companies that are managed by corporate service providers in Vanuatu do not register as overseas companies.

Recommendation

259. Periodically, corporate service providers should submit information on foreign incorporated companies that are administered or otherwise operating in Vanuatu. Each service

provider should provide the name and country of incorporation of each foreign incorporated company that they administer or operate.

GP7: Company service providers must fulfill their obligations as directors effectively and should not be able to assign their responsibilities to others, or know little or nothing about the companies that they direct. While they may be able to assign their functions to others they remain ultimately responsible.

Comment

260. The judgment reached in 1998 by the Vanuatu Supreme Court in the case between McCormack (plaintiff), and Barratt and Sinclair (defendants), highlights the inherent dangers in failing to properly discharge the duties of a director. Similar difficulties may arise where directors assign their powers by a general power of attorney.

Recommendation

261. Under codes governing the standards of conduct and diligence expected from service providers (Box 1), company service providers should be required to demonstrate that reasonable care has been taken to have knowledge of the activities of the companies for which they act as director.

262. The regulator should have the power and duty to disqualify company service providers, and staff members concerned, where they fail to act in accordance with these standards.

GP8: Company service providers should have effective anti-money-laundering measures in place, including know-your-customer rules, record keeping, staff training, and reporting procedures. Providers should be obliged to establish the identity of the beneficial owners and directors of the companies to which they provide services.

Comment

263. Except to the extent to which corporate service providers “administer or manage funds,” they are not required to have anti-money-laundering measures in place in line with requirements established in the FTRA.

Recommendations

264. All service providers should be required by statute to obtain and verify information on beneficial ownership and directors, to keep records, to train staff, and to report suspicions to the FIU.

Box 1. Sketch of Principles of Legislation to Register and Regulate Company Service Providers

The regulator should assess applicants for company service provider licenses to ensure that they are fit-and-proper persons to provide such services, in terms of integrity, competence, financial standing, structure, and organization. This should involve an assessment of the owners, controllers, officers, and key personnel of the applicant, and the business that the applicant proposes to carry on. The regulator should be satisfied that there is an adequate “span of control” (at least two individuals controlling the business; at least one jurisdiction requires three), and a physical presence in the country.

Following assessment of an application, the regulator should grant or refuse a license, or grant a license subject to conditions (which might also later be amended, added to, or withdrawn). It should be an offence to act as a service provider without being licensed. It should also be open to the regulator, in case of need, to bar individual officers or key personnel from taking part in the provision of the company service provider’s activities.

Following registration, company service providers should be supervised on an ongoing basis. The regulator should be entitled to object to any changes in ownership and directors, and should be notified in advance. It should be an offence to fail to notify the regulator of any change. Legislation should also provide for audited financial statements, external certification of compliance with regulatory standards, the segregation of client assets, and restrictions on advertising. Auditors should be provided with a gateway through which to report anything relevant to the regulator’s function.

Provision should be made for codes governing the standards of conduct and diligence expected from company service providers, and the regulator should have the power and duty to disqualify providers failing to discharge their activities adequately in terms of the codes. Codes should oblige providers:

- to conduct business with integrity;
- to have the highest regard for the customers’ interests;
- to organize and control their affairs effectively for the proper performance of business activities and to be able to demonstrate the existence of adequate risk-management systems. (This includes complying with anti-money-laundering legislation and guidance, ensuring that employees hold relevant qualification and experience (which should be prescribed), keeping up to date with industry and technical developments, and establishing a dedicated resource to ensure compliance with legislation and to monitor operational performance);
- to be transparent in business arrangements;
- to maintain and be able to demonstrate the existence of both adequate financial resources and adequate insurance; and
- to deal with the regulator and other authorities in an open and cooperative manner.

Legislation should provide effective and independent powers, including the power to monitor and supervise company service providers, to inspect their activities, and to investigate potential breaches of legislation and codes. While there are no accepted standards governing the frequency of visits, an on-site inspection program should cover all company service providers at least once every three years. There should be a clear statutory basis for reviewing underlying customer files and obtaining information to assist in regulatory matters. It should also be an offence to knowingly or recklessly make false statements or to provide false and misleading information to the regulator, and to obstruct the regulator during a statutory investigation.

Legislation should also provide effective sanctions. In addition to the power to revoke or set conditions on a license, the regulator should be able to issue directions to require anything to be done or omit to be done, to issue public statements (to “name and shame”), and to fine. An appeals procedure will also be needed. The regulator should also make maximum use of civil law procedures, not least for calling in persons to manage or wind up businesses, and for restraint and recovery of assets.

Offences should be subject, on conviction, to a fine, imprisonment, or both.

X. ASSESSMENT OF ANTI-MONEY-LAUNDERING MEASURES⁷

A. Introduction

Legal framework

265. The relevant legislation and regulations reviewed by the mission are as follows:

- Financial Institutions Act, 1999;
- Banking Act, 1970;
- Insurance Act, 1973;
- Trust Companies Act, 1971;
- Financial Transactions Reporting Act, 2000;
- Guidelines for Financial Institutions issued by the FIU;
- Anti-terrorism regulations under the Charitable Associations Act;
- Serious Offences (Confiscation of Proceeds) Act, 1989;
- Mutual Assistance in Criminal Matters Act, 1989;
- International Companies Act, 1992;
- Companies Act, 1986;
- Extradition Act, 1988.

266. The authorities informed the mission that a Bill for the United Nations Act (2002) and a Bill for the International Convention for the Suppression of the Financing of Terrorism Act (2002) are to be placed before parliament.

267. The primary legal framework for anti-money laundering (AML) measures in Vanuatu is based upon the Serious Offences (Confiscation of Proceeds) Act, which criminalizes money laundering and provides for the confiscation of the proceeds of crime; the Mutual Assistance in Criminal Matters Act, which provides for international cooperation; and the FTRA, which provides four major pillars, i.e., customer identification, record keeping, suspicious transaction reporting, and the establishment of an FIU.

268. In addition, the FIU and the RBV have issued guidelines and practice notes, respectively, on the anti-money-laundering obligations of regulated entities.

269. These measures are augmented by provisions in the Financial Institutions Act, which require the retention of certain documents, and enhanced due diligence for suspect transactions and customers. In addition, the Act requires fit-and-proper tests for significant shareholders and management of domestic banks upon licensing, and the Insurance Act requires fit-and-proper tests for officers of domestic insurers upon licensing. The Banking Act and the Financial

⁷ The April 2002 version of the Fund and Bank Methodology for Assessing Legal, Institutional, and Supervisory/Regulatory Aspects of Anti-Money Laundering was used for this assessment.

Institutions Act prohibit a person convicted of dishonesty from acting as an officer of a bank. Money laundering is not specifically included as an extraditable offence under the Extradition Act.

270. Various regulations have been put in place for combating terrorist financing.

Institutional framework

271. The FTRA gives a pivotal role to the FIU established in the State Law Office. Its functions are to:

- receive suspicious transaction reports (STRs) given by financial institutions;
- disseminate STRs to law enforcement and regulatory agencies;
- conduct investigations to ensure compliance with the Act;
- receive information from domestic and foreign regulatory or law enforcement bodies in relation to the investigation or prosecution of money laundering;
- issue guidelines regarding record keeping and reporting obligations; and
- provide training programs for financial institutions about record keeping and reporting obligations.

272. Since the start of its operation up to the end of 2001, the FIU received 110 STRs, 38 of which were from the domestic banks, 1 from the casino, and 71 from interactive gaming operators. The STRs from the interactive gaming operators were brought to the attention of the regulator of the interactive gaming industry, and 5 other STRs were referred to the police for investigation. Although it has issued guidelines on a couple of occasions, the FIU has not yet initiated any investigations into compliance, neither has it provided training programs, other than a few seminars conducted for the domestic banking sector.

273. The financial regulators have played a minimal role in enforcing the AML requirements in the banking sector. The offshore banking, insurance, and trust companies' sectors are not currently subject to effective supervision, while company service providers, money remitters, and money changers fall outside any regulatory regime.

274. The Vanuatu police force is responsible for investigating money-laundering offences, while the public prosecutor is responsible for prosecutions of money-laundering offences. To date, there have been no prosecutions. The attorney general is responsible for international cooperation on money-laundering matters.

Compliance process

275. Since the enactment of the FTRA, compliance by banks has been verified only by off-site review through the submission of the internal policies and procedures to the FIU, and/or the financial regulators. There has been no follow-up action on the internal policies and procedures submitted. No on-site verification has been carried out by either the FIU or the financial regulators. In other sectors, there has been almost no effort to ensure the compliance of the AML requirements. While the FIU is given the power to investigate to ensure compliance with the FTRA, its power to enter the premises of a financial institution is limited to checking compliance with customer identification and record keeping requirements. The power of entry does not extend to ensuring compliance with suspicious transaction reporting obligations. In addition, the FTRA is unclear as to whether a search warrant is required before access to the records of financial institutions can be gained by the FIU. Further, if on-site examinations are allowed routinely, another limitation in the Act is that protection from liability for financial institutions for disclosure of information does not extend to disclosures made pursuant to such examinations.

B. Assessment

276. The enactment of the Serious Offences (Confiscation of Proceeds) Act, the Mutual Assistance in Criminal Matters Act, the FTRA, and the subsequent establishment of an FIU in the State Law Office have significantly strengthened the legal and institutional framework in Vanuatu to prevent money laundering. The government has also introduced measures to fight terrorist financing by passing relevant subsidiary legislation to implement the UN Convention for the Suppression of the Financing of Terrorism.

277. However, there still exist a number of significant loopholes. There is a need for amendments to the FTRA to strengthen customer identification requirements and to the Serious Offences (Confiscation of Proceeds) Act to include powers to freeze and to confiscate the proceeds and instrumentalities of crime. Secondly, the mechanism to ensure compliance with AML requirements needs to be strengthened. The legal uncertainty with respect to the investigative powers of the FIU and the on-site supervisory power of the financial regulators vis-à-vis the secrecy provisions in the Companies Act and the International Companies Act (discussed in section II) should be cleared, so as to permit the regulators and the FIU to carry out on-site verification of compliance with AML requirements. Thirdly, the FIU needs to be provided with an operational strategy and adequate resources to carry out its functions. Fourthly, fit-and-proper tests with respect to directors, significant shareholders, and management of financial service providers should be clearly and formally provided for in the legislation. The requirement should be applicable not only at the time of licensing, but also as an ongoing requirement subsequently. The Vienna, Palermo, and Suppression of Financing of Terrorism Conventions have not been signed or ratified. Money laundering is not specifically included as an extraditable offence under the Extradition Act. The provisions for international cooperation are limited by the requirement that a treaty is required before legal assistance can be provided to noncommonwealth countries as small jurisdictions like Vanuatu face difficulty in engaging other jurisdictions to enter into mutual legal assistance treaties with them.

278. Core arrangements for supervision and monitoring need to be developed, as the FIU and the financial regulators do not verify compliance with the AML requirements by banks and insurers. The RBV, which regulates domestic banks, has devoted its supervisory power to the banks' loan assessment and has not verified compliance with the AML requirements through its on-site examinations. The VFSC, which regulates offshore banks, all insurers and the trust companies, operates under weak legislation and has insufficient resources. The FIU and the financial regulators need to formulate a coordinated strategy for the on-site verification of the AML requirements in each sector. There are no appropriate supervisory procedures applied to the offshore banking and insurance sectors; there has been no effective regime to supervise trust companies; and company service providers are not subject to any government regulation.

C. Key Areas for Improvement

Customer identification

279. The customer identification provision in the FTRA leaves much scope for exceptions. The requirement to identify customers arises only when a person conducts a transaction through a financial institution, *and* the amount of transaction exceeds Vt 1 million (about \$7,000). The requirement to identify the beneficial owner also only arises when the amount of the transaction exceeds Vt 1 million. The FTRA does not create a statutory requirement for financial institutions to identify a customer at account opening on all occasions, although the *Guidelines for Financial Institutions* issued by the FIU require financial institutions to identify every new customer. However, the *Guidelines* do not have the force of law, and therefore they seem to go beyond the scope of the law.

280. In addition, section 10(4) of the FTRA and the *Guidelines* provide exemption from the customer identification requirement for those transactions conducted through another financial institution. Financial institutions are widely defined in the Act. For example, if a lawyer or an accountant, acting as a financial intermediary, carries out a banking transaction for a client abroad, a bank is not required to seek the relevant identification information on that client. This is a significant risk when dealing with offshore entities. The requirement is also waived under section 10(4) for *any* transaction that is part of an established business relationship with a person who has already produced satisfactory evidence of identity.

281. In addition, the Act and the *Guidelines* lack clarity on what identification documents are acceptable for the identification of individual, as well as corporate, customers.

Recommendation

282. Section 10 of the FTRA should be amended so as to require customer identification on all account openings, for all intermediaries acting on behalf of such customers, and when establishing any business relationship. Subsequent verification should only be needed when there are doubts about the transaction or the identity of the customer. Customer verification can be exempted when dealing with a financial institution that is under prudential regulation and also subject to similar customer verification obligations. The FIU should issue a new guideline delineating acceptable identification documents.

On-site verification of compliance of the AML requirements

283. To date, there has been no effort either by the FIU or the financial regulators to verify the compliance with the AML requirements by financial institutions for various reasons. First, there is legal uncertainty with respect to the investigative power of the FIU and the on-site supervisory power of the financial regulators vis-à-vis the secrecy provisions in the Companies Act and the International Companies Act. This uncertainty has led the authorities to hesitate to review individual account records on the premises of financial institutions. Some banks have taken the view that the on-site review of the records of individual accounts would breach those secrecy provisions and make them liable to litigation by the account holders. In addition, the manpower of the FIU has been limited and it has not produced its strategy plan, including a program for on-site inspection. Finally, the financial regulators, who also suffer from resource constraints, do not consider it a priority to ensure financial institutions' compliance with AML requirements.

Recommendation

284. The legal uncertainty with respect to the investigative power of the FIU and the on-site supervisory power of the financial regulators vis-à-vis the secrecy provisions should be clarified, so as to permit the FIU and the regulators to review random samples of individual accounts, and to verify compliance with the AML requirements. The FTRA should be amended so as to override the secrecy provisions specifically, and to protect financial institutions from liability for making disclosures pursuant to the Act.

285. In carrying out on-site verification, there should be coordination between the FIU and the financial regulators. In view of the resource constraints, one alternative would be to assign to the financial regulators the role of primary verifier so that the FIU would carry out verification only when it suspects that there is a major noncompliance in a particular financial institution. For all other financial institutions not under the supervision of financial regulators (e.g., money exchangers), the FIU should be responsible for carrying out on-site verification.

Strengthening the FIU

286. The FIU has a variety of functions. In practice, however, it has been acting mainly as the recipient of the STRs from domestic banks and has not carried out other functions for various reasons. First, it has not yet identified priorities in its multiple functions. Second, it has yet to establish an operational plan under which it carries out its duties within a specified time frame. Third, it has only two part-time staff and lacks an officer fully dedicated to its operation. In addition, the power to analyze suspicious transactions is not set out in the FTRA.

Recommendations

287. The FIU should carry its operations on the basis of a rolling strategic plan, which could cover the next 12 months. It should set a number of priority targets within specified timelines. Box 2 gives an example of such a strategic plan.

Box 2. Rolling Strategic Plan

Reaching out to “financial institutions.” Within the next six months, organize a meeting with the association or representatives of each industry that falls under the definition of “financial institution,” and increase awareness of AML requirements under the FTRA. Such a meeting is especially important for those industries other than domestic banking. Once the first meeting takes place, it may be useful to have such meetings regularly, for example, once a year. This would provide an opportunity for the FIU to give feedback on the STR system on an aggregate basis, such as the number of STRs filed during the preceding 12 months, the number of cases judged to include useful intelligence and patterns or trends of suspicious transactions identified among the STRs.

Establish an STR database appropriate to the Vanuatu situation. Within the next three months, sort the existing STRs in EXCEL or ACCESS format, and identify any patterns or trends among those STRs. Although the current *Guidelines* have a long list of examples of suspicious transactions, it relies largely on the experience of developed countries.

Introduce internal procedures for the dissemination of STRs to other agencies. Within the next three months, delineate the steps from receiving an STR, entering it into the database, and providing copies to the relevant agencies. The FIU should consult with each agency and agree on a specific contact person within each agency. It may also be preferable to conclude an MOU with those agencies to ensure confidentiality of the STRs.

Organize a meeting with the financial regulators. Within the next three months, organize a meeting with each financial regulator to discuss general compliance with the AML requirements in each industry. In the first meeting, it may be useful to discuss a strategy on role sharing between the FIU and the financial regulators. One example of such a strategy would be to agree on the choice of financial institutions that require on-site verification of compliance on the basis of past reporting performance. After the first meeting, it would be useful to have such meetings regularly, for example, every half-year, when the financial regulators may be able to brief the FIU on the level of compliance by those financial institutions inspected in the preceding six months.

288. In addition, to the formulation of a strategy plan, the FTRA should be amended to allow the FIU to analyze suspicious transactions and request further information needed from institutions and relevant agencies for this purpose.

Confiscation powers

289. The Serious Offences (Confiscation of Proceeds) Act does not specifically provide for the confiscation of property that is the proceeds of crime, instrumentalities, and other property used in the commission of crime. The definition of proceeds of crime should be widened to include property that is derived directly and indirectly from the commission of the offence. The Act does not provide for the power to freeze transactions or accounts when a money-laundering offence is suspected. Production orders do not extend to bankers' books.

Recommendation

290. Amend the Serious Offences (Confiscation of Proceeds) Act to:

- include a specific power to confiscate property that is the proceeds of crime and instrumentalities of crime;
- widen the definition of proceeds of crime;
- include a specific power to freeze transactions or accounts; and
- extend production orders to include bankers' books.

Summaries of Recommended Action Plans

Table 3. Recommended Action Plan for Cross-Sectoral Issues

Recommended Action	Priority
Undertake a fundamental review of the focus and future direction of the offshore sector.	High
Assess the RBV’s capacity to assume responsibility for prudential supervision of all sectors of both the domestic and offshore market.	High
Review the overall legal framework for the offshore and nonbank domestic sectors.	High
Cease the practice of licensing privately owned “shell” financial institutions.	High
Restrict licenses to institutions that either maintain a fully staffed office (with proper books and records in Vanuatu), or are branches and subsidiaries of recognized foreign banks, subject to effective home-country-consolidated supervision.	High
Undertake a comprehensive review of the background and activities of all offshore licensed institutions, and take action to remove any undesirable institutions.	High
Clarify, beyond all doubt, the legal authority of the supervisory authorities to have access to whatever information they might require from a licensed institution in order to perform their duties.	High
Introduce legal “gateways” to permit all the supervisory authorities to exchange information and otherwise cooperate (under conditions of confidentiality) with both domestic and foreign counterparts.	High
Introduce a common “menu” of enforcement actions that would be available for application to all institutions in both the domestic and offshore markets.	Medium
Introduce a common “fit-and-proper” requirement for shareholder/controllers, directors and managers of all financial institutions, and make it an ongoing obligation to meet the test.	Medium

Table 4. Recommended Action Plan to Improve Compliance of the Basel Core Principles—
Domestic Banks

Reference Principle	Recommended Action	Priority
Legal Framework (BCP 1.3)	Build more flexibility into the Financial Institutions Act to give the supervisor more scope to set prudential ratios appropriate to each bank.	Medium
Enforcement Powers (BCP 1.4)	Make it legally explicit that the provisions of section 28 of the Financial Institutions Act take precedence over the Companies Act.	High
Legal Protection (BCP 1.5)	Issue a statement to RBV staff setting out the policy for the indemnification of costs of defending any legal proceedings brought against staff in relation to the performance of their official duties.	Medium
Capital Adequacy (BCP 6)	Include provision for market risk when the relevant prudential guideline is next revised.	Low
Money Laundering (BCP 15)	Incorporate within the RBV's on-site examination process a review of systems and controls to guard against money laundering.	High

Table 5. Recommended Action Plan to Improve Compliance of the Basel Core Principles—
Offshore Banks

Reference Principle	Recommended Action	Priority
BCPs 1–25	Rewrite the Banking Act entirely to reflect the approach of the Financial Institutions Act.	High
	Bring the supervisory policies and procedures into line with those applying to the domestic banking sector.	High
	Confine offshore banks to those with local resident managers and records or to those that are branches or subsidiaries of banks licensed and subject to international standards of supervision in their home jurisdictions	High
	Consolidate the responsibility for supervision of offshore banking with that for the domestic banks within the RBV.	High

Reference Principle	Recommended Action	Priority
Liabilities (CP7) (cont'd)	Enforce the statutory filing of an actuarial valuation for long-term business and provide some input into acceptable assumptions in the valuation of the liabilities.	High
	Examine all reinsurance treaties at the licensing stage and on an ongoing basis, and set limitations on the acceptability of reinsurance recoverables.	Low
	Require the insurer to submit as part of its annual return, an additional report stating the full name of each of its major reinsurers (both treaty and facultative), the amount of reinsurance premium payable to each such reinsurer, the amount of debt of each reinsurer to the insurer, the amount of any deposit received from the reinsurer, and the amount of any anticipated recoveries from each reinsurer. In the event that this information reveals an unsatisfactory situation, the insurance supervisor can then intervene, using the general power to require the insurer to act in accordance with sound insurance principles.	Low
Capital Adequacy and Solvency (CP 8)	Prescribe a minimum capital requirement in the Insurance Act for all insurance companies. Where there is doubt about the ongoing maintenance of the solvency margin, the supervisor should have the power to require the insurer to submit a short-term financial scheme for restitution, subject to noncompliance with the Insurance Act.	High
	Put in place controls to ensure that an insurer can meet obligations at all times. Require quarterly management accounts (in the case of a newly licensed insurer) within six weeks, and fully audited accounts within three months of financial year-end, particularly for offshore insurance companies.	Medium
	Take a more structured approach to assessing capital adequacy, including the use of exposure spreadsheets both at the application stage and, on a proactive basis, to monitor any proposed material changes during the year. It is critical that the insurance company management and any prospective applicants are made aware of the methods used by the insurance supervisor.	Low
Derivatives and 'Off-Balance Sheet' Items (CP 9)	Issue guidance covering restricted investments, disclosure and internal controls and extend the law to encompass offshore insurance companies. In particular, investments in options, futures, or forward contracts should be prohibited.	Low
	Remove the exemption for offshore insurance companies under Section 8(2).	Low

Reference Principle	Recommended Action	Priority
<p>Reinsurance (CP 10)</p>	<p>Give the existing staff all the training necessary to have a greater understanding in the area of reinsurance. There are qualifications and courses available to improve knowledge of reinsurance.</p>	<p>Low</p>
	<p>As part of the application and on an annual basis, require an insurer seeking a license to provide details of its reinsurance arrangements. In general, the insurance supervisor needs to be satisfied that insurance companies use reinsurers with satisfactory Standard and Poors and A.M. Best's ratings.</p>	<p>High</p>
	<p>Develop guidance notes for the industry on some minimum acceptable standards in the industry, particularly in the area of catastrophe cover, and hold regular meetings with domestic property insurers to gauge a better understanding on the prevailing climate.</p>	<p>Low</p>
	<p>In addition to the annual filing of the reinsurance treaty arrangements, require insurers to provide to the insurance supervisor a statement of their major treaty and facultative reinsurers. This statement should indicate the full name of each of the major reinsurers (both treaty and facultative), whether the insurer had any connection with the reinsurers, the amounts of reinsurance premium payable to reinsurers, the amount of any debt of each reinsurer, the amount of any deposit received from the reinsurers, and the amount of the anticipated recoveries from each reinsurer under the reinsurance arrangements.</p>	<p>Low</p>
	<p>Pay greater emphasis to reinsurance catastrophe treaties and their terms and conditions. A full analysis should be performed as part of the on-site inspection process, particularly to examine per risk maximum retention relative to capital and surplus.</p>	<p>Low</p>
<p>Market Conduct</p>		
	<p>Develop guidance notes setting minimum standards for intermediaries, including minimum qualifications, a code of ethics, and proper market conduct. This should be enforced, and failure would lead to a revocation of the intermediary's license under Section 28 of the Insurance Act.</p>	<p>Medium</p>
	<p>Outline provisions in a policy statement, to include, for example, protection against fraudulent representation; protection against cancellation of a policy for the policyholder; protection against illegal contracts; protection against the practice of rebating; misstatement of age and health; requirements to file proposed policies with the insurance supervisor for prior approval; rate setting; surrender of policies; protection of minors; and nonforfeiture.</p>	<p>Low</p>

Table 7. Recommended Action Plan to Improve Practices Relating to Trust Service Providers

Good Practice	Recommended Action	Priority
<p>Only fit-and-proper persons should be able to offer trust services. Appropriate sanctions should be available to the regulator to deal with those that are not licensed, or do not act in a fit-and-proper manner. The regulator should have effective and independent enforcement powers, including the power to monitor and supervise licensed trust service providers, to inspect their activities, and to investigate potential breaches of rules, regulations and laws.</p>	<p>Extend the scope of the Trust Companies Act to address all trust activities.</p>	<p>Medium</p>
	<p>Vest the powers of licensing and supervision in the regulator, and provide a greater focus on assessing the fitness and propriety of applicants and licensees.</p>	<p>High</p>
	<p>Provide additional enforcement powers and sanctions to the regulator.</p>	<p>High</p>
<p>The regulator should have the power to cooperate with domestic and international agencies that share similar supervisory responsibilities. This should include a power to spontaneously provide information, and to collect information to assist another regulator.</p>	<p>Establish a gateway through which to cooperate with other regulators.</p>	<p>High</p>
<p>At any time, a country’s authorities should have a means of establishing the settlors, protectors, and beneficiaries of trusts that are settled in their jurisdiction.</p>	<p>Establish a legal requirement for trust service providers to hold information on settlors, protectors, and beneficiaries that is subject to external monitoring.</p>	<p>High</p>
<p>Trusts should not be used to obscure the true ownership of assets, frustrate legitimate claims, or defraud creditors.</p>	<p>Issue codes of practice requiring trust service providers to understand and verify the purpose of each trust settled.</p>	<p>Medium</p>
<p>At any time, a country’s authorities should have a means of access to basic financial information relevant to the activities of trusts. Trust service providers should be obliged to make proper disclosure to beneficiaries, any co-trustees, and any protector, and to produce, submit and preserve accounts.</p>	<p>Issue codes of practice requiring trust service providers to produce, submit, and preserve accounts as appropriate.</p>	<p>Medium</p>
<p>Trust service providers should have in place effective anti-money-laundering measures, including know-your-customer rules, record keeping, staff training, and reporting procedures. Providers should be obliged to establish the identity of the “customer” to which they provide services.</p>	<p>Extend the scope of anti-money-laundering legislation to cover all trust service providers.</p>	<p>High</p>

Table 8. Recommended Action Plan to Improve Practices Relating to Company Service Providers

Good Practice	Recommended Action	Priority
<p>Only fit-and-proper persons should be able to offer company services. Appropriate sanctions should be available to the regulator to deal with those that are not licensed, or do not act in a fit-and-proper manner. The regulator should have effective and independent enforcement powers, including the power to monitor and supervise licensed company service providers, to inspect their activities, and to investigate potential breaches of rules, regulations and laws.</p>	<p>License company service providers and introduce a full supervisory regime.</p>	<p>High</p>
<p>The regulator should have the power to cooperate with domestic and international agencies that share similar supervisory responsibilities. This should include a power to spontaneously provide information, and to collect information to assist another regulator.</p>	<p>Establish a gateway through which to cooperate with other regulators.</p>	<p>High</p>
<p>At any time, a country's authorities should have a means of establishing the ultimate beneficial owners, directors, and activities of companies that are incorporated in their jurisdiction, and foreign incorporated companies administered therefrom.</p>	<p>Establish a legal requirement for company service providers to hold information on beneficial owners, directors, and activity that is subject to external monitoring.</p>	<p>High</p>
<p>The use of companies in sensitive activities that risk bringing the center into disrepute should be avoided.</p>	<p>Publish a list of sensitive activities.</p>	<p>Medium</p>
<p>At any time, a country's authorities should have a means of access to basic financial information relevant to the activities of companies. Without this, the nature, scale and purpose of the activities of individual companies are not likely to be known, and the greater the risk of abuse must be.</p>	<p>Issue codes of practice requiring company service providers to maintain or request books and records.</p>	<p>Medium</p>
<p>Authorities should be aware of the extent to which foreign incorporated companies are administered or otherwise operating in a jurisdiction, since there are risks in hosting business about which they have no knowledge.</p>	<p>Require periodic submission by company service providers of information on foreign incorporated companies that are administered or otherwise operating in Vanuatu.</p>	<p>Low</p>

Good Practice	Recommended Action	Priority
Company service providers must fulfill their obligations as directors effectively and should not be able to assign their responsibilities to others, or know little or nothing about the companies that they direct. While they may be able to assign their functions to others they remain ultimately responsible.	Issue codes of practice requiring company service providers to demonstrate that reasonable care has been taken to understand the activities of the companies for which directors are provided.	Medium
Company service providers should have in place effective anti-money-laundering measures, including know-your-customer rules, record keeping, staff training, and reporting procedures. Providers should be obliged to establish the identity of the beneficial owners and directors of the companies to which they provide services.	Extend the scope of anti-money-laundering legislation to cover company service providers.	High

Table 9. Recommended Action Plan to Improve Practices Relating to AML/CFT

AML/CFT Requirements	Recommended Action	Priority
Part 1: AML/CFT in the Legal and Institutional Framework		
Suggested actions for the legal and institutional arrangements		
Customer due diligence	Amend section 10 of the FTRA so as to require customer identification on all account opening and to narrow the exceptional circumstances where identification requirement is waived.	High
	Issue a new guideline on acceptable identification documents.	Medium
	Make inclusion of originator information on fund transfers mandatory.	High
Record keeping	Amend section 11 of the FTRA so that records have to be kept for at least 5 years after the business relationship or transaction has ceased.	High
Suspicious transactions reporting	Amend section 7 of the FTRA to expand the protection for financial institutions to any information given to the FIU by financial institutions.	High
	Require the VFSC and the auditors to report suspicious transactions.	High
AML/CFT internal controls	Include a requirement in the FTRA for a compliance officer to be appointed.	Medium
Sanctions		
Integrity standards	Introduce a fit-and-proper test at the time of licensing and ownership change under the relevant legislation.	High
Criminalization of money laundering and terrorism financing	Introduce provisions to criminalize the financing of terrorism	High
Confiscation of proceeds of crime or assets	Amend the Serious Offence (Confiscation of Proceeds) Act to include full confiscation and freeze powers and to extend ambit of production orders.	Medium
Process for receiving, analyzing, and disseminating disclosures of financial information and intelligence	Provide the FIU with more manpower to carry out its functions under the FTRA.	High
	Clear the legal uncertainty with respect to the FIU's investigative power to ensure compliance with the Act by financial institutions.	High
	Give the FIU statutory power to analyze transactions.	Medium

AML/CFT Requirements	Recommended Action	Priority
International cooperation in AML/CFT matters	Include money laundering as an extraditable offense under the Extradition Act. Extend the Mutual Assistance in Criminal Matters Act so that legal assistance can be rendered to noncommonwealth countries without the need for a treaty.	Medium
Part 2: AML/CFT in the Prudentially Regulated Sectors		
Suggested actions for AML/CFT core criteria		
Organizational and administrative arrangements	Provide the FIU with more manpower to verify compliance with the AML requirements by banks and insurers.	High
	Clear the legal uncertainty with respect to the investigative power of the FIU and the on-site supervisory power of the financial regulators vis-à-vis the secrecy provisions in the Companies Act and the International Companies Act, to permit the FIU and the regulators to carry out on-site verification of compliance with the AML requirements.	High
	Strengthen coordination between the FIU and the financial regulators in ensuring compliance by banks and insurers.	High
Customer identification and due diligence	Organize a meeting between the FIU and the representatives of each industry to increase the awareness of the importance of the latter's compliance with customer identification requirement.	Medium
	Initiate a program of on-site examinations to verify compliance by the financial institutions, including interviews with compliance officers and relevant bank employees.	High
	Convene a meeting on a regular basis between the financial regulators and the FIU to review compliance with the reporting requirements in each industry. Based on the input from the financial regulators, the FIU should consider initiating its own on-site examination to ensure general compliance by financial institutions.	High

AML/CFT Requirements	Recommended Action	Priority
Monitoring and reporting suspicious transactions	<p>Organize a meeting between the FIU and the representatives of each industry to increase the awareness of the importance of their compliance with suspicious transaction reporting. The FIU should also consider providing the industries with the feedback, at least on the aggregate basis, on the STRs submitted.</p> <p>Initiate a program of on-site examinations to verify compliance by the financial institutions, including interviews with compliance officers and relevant bank employees.</p> <p>Convene a meeting on a regular basis between the financial regulators and the FIU to review compliance with the reporting requirement in each industry. Based on the input from the financial regulators, the FIU should consider initiating its own on-site examination to ensure general compliance by financial institutions.</p>	<p>Medium</p> <p>High</p> <p>High</p>
Record-keeping, compliance and audit	<p>Organize a meeting between the FIU and representatives of each industry to increase the awareness of the importance of their compliance with record-keeping.</p> <p>Initiate a program of on-site examinations to verify compliance by the financial institutions with the record-keeping requirement on the basis of samples randomly selected of individual accounts.</p>	<p>Medium</p> <p>High</p>
	<p>Convene a meeting on a regular basis between the financial regulators and the FIU to review compliance with record-keeping requirements in each industry. Based on the input from the financial regulators, the FIU should consider initiating its own on-site examination to ensure general compliance by financial institutions.</p>	<p>High</p>
Cooperation between supervisors/regulators and competent authorities	<p>Introduce a legal “gateway” for the regulator of the offshore banking sector to exchange information with the supervisory agencies in other countries.</p>	<p>High</p>
Licensing and authorizations		
Suggested additional actions for AML/CFT measures in the banking sector		
Customer identification and due diligence	<p>Issue a guideline on customer identification required in the case of high-risk customers, transactions through lawyers and accountants, nonface-to-face customers and fund transfers.</p>	<p>Medium</p>

AML/CFT Requirements	Recommended Action	Priority
Monitoring and reporting suspicious transactions		
Record-keeping, compliance and audit		
Cooperation between supervisors/regulators and competent authorities		
Suggested additional actions for AML/CFT measures in the insurance sector		
Customer identification and due diligence	Strengthen the capacity of the financial regulator, in terms of new legislation and more resources, to permit it to monitor and enforce compliance with the requirements.	High
Monitoring and reporting suspicious transactions	As above.	High
Record-keeping, compliance and audit	As above.	High
Licensing and authorizations	As above.	High
Part 3: AML/CFT in Other Sectors		
Suggested actions for AML/CFT measures for other service providers		
Organization and administrative arrangements	Strengthen the manpower of the FIU to permit it effectively to enforce the AML requirement on trust companies.	High
	Strengthen the financial regulator’s capacity to supervise trust companies, in terms of new legislation and more resources.	High
	Introduce a system to regulate and supervise company service providers.	High
Customer identification and due diligence	Strengthen the supervisory capacity of the financial regulator, in terms of new legislation and more resources, to permit it to monitor and enforce customer identification requirements.	High
Monitoring and reporting of suspicious transactions	As above.	High
Record-keeping	As above.	High
Cooperation among competent authorities	Establish a statutory gateway through which to cooperate with other regulators.	High
Licensing and authorizations	Strengthen the supervisory capacity of the financial regulator, in terms of new legislation and more resources, to permit it to apply an effective fit-and-proper test at the licensing stage.	High

Authorities' Response to the Assessment

291. The Government of the Republic of Vanuatu provided the Monetary and Financial Systems Department of the Fund with a letter and table outlining the steps it has taken to address both the general and specific recommendations, and underlining its commitment to the reform agenda required to implement the recommendation. The authorities noted that, since being presented with the Report in May 2002, the government has moved quickly to ensure that its recommendations are considered and implemented where appropriate.

In particular:

- The government has established a high-level committee whose membership is comprised of senior officials from the RBV, VFSC, the State Law Office, the Office of the prime minister, and the ministry of finance and economic management. The role of the committee is to review the report and to recommend what action should be taken to give effect to its recommendations.
- New legislation has been enacted to strengthen supervisory arrangements for international (offshore) banks. This legislation introduces supervisory standards consistent with international requirements and requires all offshore banks to maintain a physical presence in Vanuatu consistent with the paper entitled, "Shell Banks and Booking Offices," circulated by the Basel Committee on Banking Supervision;

292. The authorities note that they will face some capacity constraints in implementing the recommendations of the report within a short time frame, but emphasize their commitment to improving standards in Vanuatu. The legislative and implementation measures taken to date demonstrate this commitment.

293. Following is the detailed response, arranged by recommendation, and sector. To minimize repetition, points have been grouped under generic headings wherever possible.

Table 10. Authorities' Detailed Response

Topic	Recommendation	Response
General Matters		
Cost benefit analysis and review of the focus of the offshore sector	Authorities should undertake a cost-benefit analysis of the offshore sector and undertake, in consultation with industry, a fundamental review of the focus of the business activities in the offshore industry.	Recommendation accepted. The government will engage stakeholders to discuss future directions for the industry so as to ensure an efficient allocation of resources.
Review legal framework	Authorities must review the legal framework to ensure that there is specialist financial services legislation, which will give regulators legal authority and power to enforce their decisions.	Recommendation accepted. The government has passed the International Banking Act, which takes effect from January 1, 2003 (refer section on Offshore Banks). In addition, the government is reviewing legislation covering the insurance, trust company and company service providers sectors and is aiming to introduce new comprehensive legislation, which is consistent with international standards, in the second half of 2003.
Organization, independence and resources	Authorities should review the structure and legal framework supporting the VFSC and ensure that it is adequately resourced. More generally, authorities should consider if it is appropriate to transfer the supervisory functions of the VFSC to the RBV.	<p>Recommendation accepted. The government has established a high level committee, comprising senior members of the government and supervisory bodies, to review this and other recommendations of the report. The committee will be seeking to ensure that, whatever the role of the supervisory bodies; there will be effective supervision of Vanuatu's finance industry.</p> <p>The VFSC Act has been amended in November 2002, to change the composition of the board. Consideration is being given to other areas to improve and strengthen the governance of the VFSC.</p>
Access to information	Regulators must have legal authority to access information, and laws should be clear so that there are no conflicts between specific supervisory laws and secrecy provisions contained in the Companies Act.	Recommendation accepted. Existing legislation will be reviewed to ensure that supervisory requirements to access information cannot be overridden. Amendments to the Financial Institutions Act (domestic bank law) in November 2002 and the recently enacted International Banking Act give explicit powers to the supervisors to access information. The FTRA will also be amended to allow for greater sharing of information between supervisory authorities and the FIU.
Review of existing participants in offshore sector	Authorities should undertake a review of the background and activities of all	Recommendation accepted. This process is ongoing and will be addressed as part of the implementation of new legislation covering

Topic	Recommendation	Response
	offshore licensed financial institutions.	the offshore sector.
Cross-border cooperation	Supervisors should be able to exchange information with overseas counterparts.	Recommendation accepted. The International Banking Act provides for the supervisor to exchange information with other regulators. Legislation covering the nonbank sectors ⁸ will be reviewed to ensure that such gateways for the exchange of information exist.
Enforcement powers	There should be more clearly defined courses of action for enforcement measures taken by both the RBV and VFSC.	The recommendation is accepted in principle.
“Fit-and-proper” criterion	Regulatory laws should include a requirement that the fit-and-proper criterion should be met on a continuous basis in respect of all persons who act as significant shareholders, controllers and managers of any licensed institution.	Recommendation accepted. The RBV issued a prudential guideline on ‘fit-and-proper’ criterion for management and directors in September 2002. The Financial Institutions Act has been amended to support this Guideline. The International Banking Act also includes ‘fit-and-proper’ criterion for management and directors. The supervisor can require removal of a person who is deemed no longer to meet the fitness and propriety criteria. The supervisor is required to give approval to changes in ownership or share transfers in excess of 10 percent of the issued capital of the company. Similar fitness and propriety criterion will be included in legislation covering the nonbank sector.
Domestic Banking		
Consistent treatment across domestic and offshore banks (BCP 1.1)	There are no mechanisms to ensure consistent supervisory treatment of domestic and offshore banks. Communications between the RBV and the VFSC (which supervises the offshore sector) are informal and limited.	Recommendation accepted. With the enactment of the International Banking Act in November 2002, the RBV now has supervisory responsibility for offshore banks.
Suitable legal framework (BCP 1.3)	The Financial Institutions Act should be amended to give the RBV greater flexibility to set prudential ratios appropriate to each bank.	Recommendation accepted. The Financial Institutions Act was amended in November 2002 to provide the RBV with increased flexibility.
Enforcement powers (BCP 1.4)	Make it legally explicit that the provisions of section 28 of the Financial Institutions Act take precedence over	The RBV accepts this, but is of the opinion that the provisions of the Financial Institutions Act (FIA) apply. Section 4(1) of the FIA states that in the event of any conflict with the

⁸ For the purposes of the assessment and this response, the term ‘nonbank sector’ refers to insurance companies, trust companies, and company service providers.

Topic	Recommendation	Response
	the Companies Act.	Companies Act [CAP 191] the provisions of the FIA prevail. The Bank would be prepared to pursue legal action against a licensee that refused to permit the Bank to conduct an on-site examination.
Legal protection (BCP 1.5)	It should be specified in legislation that RBV staff would be protected for costs of defending any action.	The RBV accepts this principle. Rather than specify this in legislation, the bank has addressed this issue by specifically stating in the <i>Staff Handbook</i> , which sets out the terms and conditions of employment, that staff will be protected for costs of any action while discharging their duties in good faith.
Capital adequacy (BCP 6)	The capital adequacy framework does not incorporate any provision for market risk.	The RBV accepts this observation. The market risk held by domestic banks is negligible and the RBV will continue to monitor developments.
Other risks (BCP 13)	There is no procedure for assessing operational risks.	The RBV accepts this observation. Under arrangements with banks' external auditors, as outlined in prudential guideline 5, the RBV has recently asked external auditors to review aspects of bank's risk management policies in relation to operational risk management. In future years, the RBV will ask that auditors review other aspects of banks' risk management policies.
Money laundering (BCP 15)	The RBV should extend its on-site examination program to include an assessment of a bank's anti-money-laundering systems and controls.	Recommendation accepted. In July 2002, the RBV issued prudential guideline 9: Customer Due Diligence. The guideline is based on the principles outlined by the Basel Committee on Banking Supervision in its paper, " <i>Customer Due Diligence for Banks</i> ." The RBV has developed an on-site inspection manual and has conducted on-site AML visits. Further inspections, covering domestic and international banks, are scheduled for 2003.
Offshore Banks		
Review offshore banking legislation and supervisory framework	The Banking Act should be rewritten to bring its provisions relating to offshore banks broadly into line with those of the Financial Institutions Act. This should then be followed by implementation of guidelines and supervisory processes for the offshore banking sector that parallel those presently in place in the domestic sector. Supervisory responsibility for the sector to be transferred to the RBV.	Recommendation accepted. The International Banking Act was passed by parliament in November 2002 and came into effect on January 1, 2003. The Act provides for the RBV to supervise the operations of offshore banks. The revised Act addresses the concerns identified in the assessment and in summary: <ul style="list-style-type: none"> • The Act confers a wide range of powers on the RBV, including: the power to issue and revoke banking licenses; conduct on-site examinations; request data; place limits on the type and nature of business

Topic	Recommendation	Response
		<p>undertaken by banks; and, issue directives and prudential guidelines.</p> <ul style="list-style-type: none"> • The Act specifies objective criteria for authorization, including an assessment of the bank’s owners. There will also be ‘fit-and-proper’ requirements at authorization and on an ongoing basis. • Licensees will be required to maintain a physical presence in Vanuatu with meaningful mind and management located within the jurisdiction. The existence of a local agent or low-level staff will not constitute physical presence. • Licensees will be required to meet a minimum capital requirement of US\$0.5 million. The capital requirement would be adjusted to reflect the size of the operation and the nature of risks undertaken by licensees. • Licensees will be subject to on- and off-site analysis and review. Licensees will be required to submit statistical data to the RBV. Data and other statistical information provided would be subject to review by the licensee’s external auditor. The RBV will conduct on-site inspections to review risk management policies in the areas of credit risk and anti-money laundering. • The Act provides for the RBV to share information with other regulatory bodies both domestically and internationally. <p>In addition, the RBV has developed prudential guidelines and statistical collections for offshore banks.</p> <p>Existing international banks and other exempt financial institutions licensed under the Banking Act [CAP 63] will be taken to be issued with a license under this Act to continue to carry on banking business. This license, which will commence on January 1, 2003, is to be valid for one year, and during this period license holders are not required to maintain a physical presence in Vanuatu or to meet minimum capital adequacy provisions. However, they are subject to all other</p>

Topic	Recommendation	Response
		provisions of the Act.
Insurance Sector		
<p>Review insurance industry legislation and supervisory framework</p>	<p>Review the Insurance Act so as to provide a sound base for effective regulation. Consideration to be given to a complete revision of the Act, particularly in the areas of regulatory independence, licensing, fit-and-proper tests, financial reporting, cross-border cooperation and sanctions.</p>	<p>Recommendation accepted. The VFSC requested that AESOP undertake a review of insurance supervision in Vanuatu to address the issues identified by the assessment. AESOP has completed its review and a report has been presented to the VFSC Board that outlines a planned course of action. The four stages will be:</p> <ol style="list-style-type: none"> 1. The VFSC to approve the project (completed 29 October 2002). 2. Commence drafting a new Insurance Act. 3. Train insurance supervisors. 4. Establish office systems and procedures for insurance supervisors. <p>The government proposes that new legislation be introduced into parliament in the second half of 2003, which will rectify the deficiencies in existing legislation.</p>
Trust Service Providers		
<p>Review trust company legislation and supervisory framework</p>	<p>Vanuatu should give consideration to reviewing trust legislation to ensure that it is consistent with best practice.</p>	<p>Recommendation accepted. The government proposes that new legislation be introduced into parliament in the second half of 2003, which will rectify the deficiencies in existing legislation. Revised legislation will address areas such as:</p> <ul style="list-style-type: none"> • Licensing arrangements, including an assessment of fitness and propriety, and the ability to impose restrictions on licenses. • Changes in ownership to be subject to regulatory approval. • The regulator to be able to exercise all responsibilities currently held by the minister, and intended for the inspector of trust companies under the Trust Companies Act, which provide for a power to require the provision of information and documents, to instigate investigations, and to enter and search premises. • Provide for clear and unambiguous access to client files by the regulator. • Provision of annual audited financial

Topic	Recommendation	Response
		<p>statements.</p> <ul style="list-style-type: none"> • Power to collect statistical data. • Gateways for the regulator to discuss issues with other regulatory bodies. • Establishment of codes governing the standards of conduct expected of participants in the sector. <p>In addition, the FTRA will be reviewed and strengthened if necessary to require trust service providers to hold up-to-date information on the settlors, protectors and beneficiaries of all trusts for which they act.</p>
Company Service Provider Sector		
<p>Review company service provider supervisory framework</p>	<p>Vanuatu should give consideration to reviewing the company service provider sector to ensure that practices are consistent with best practice and that participants are fit-and-proper persons to provide such services.</p>	<p>Recommendation accepted. The government proposes that new legislation be introduced into parliament in the second half of 2003, which will rectify the deficiencies in current arrangements and provide for ongoing supervision of the sector. Areas that will be addressed include:</p> <ul style="list-style-type: none"> • Introduction of a licensing regime, including an assessment of fitness and propriety and the ability to impose restrictions on licenses. • Changes in ownership to be subject to regulatory approval. • Requirement for the provision of audited accounts • Gateways for the regulator to discuss issues with other regulatory bodies. • Ability to conduct on-site inspections and allow clear and unambiguous access to client files by the regulator. • Establishment of codes governing the standards of conduct expected of participants in the sector. <p>In addition, the FTRA will be reviewed and widened to ensure that company service providers are required to obtain and verify information on beneficial ownership and directors, to keep records, to train staff, and to report suspicious transactions to the FIU.</p>

Anti-Money-Laundering Measures		
Strengthen anti-money laundering legislation	<p>Amend the FTRA to strengthen customer identification requirements, and the Serious Offences (Confiscation of Proceeds) Act to include powers to freeze and to confiscate the proceeds and instrumentalities of crime;</p> <p>Mechanisms to ensure compliance with AML requirements need to be strengthened. Remove legal uncertainty with respect to the investigative powers of the FIU and the on-site supervisory power of the financial regulators vis-à-vis the secrecy provisions in the Companies Act and the International Companies Act, so as to permit the regulators and the FIU to carry out on-site verification of compliance with AML requirements;</p> <p>FIU needs to be provided with an operational strategy and adequate resources to carry out its functions; and</p> <p>Fit-and-proper tests with respect to directors, significant shareholders and management of financial service providers should be clearly and formally provided for in legislation.</p>	<p>Recommendations accepted. A policy paper has been prepared for consideration by the Council of ministers that proposes a number of amendments to the FTRA. The following amendments, which in some instances go beyond those proposed by the IMF, have been proposed:</p> <ul style="list-style-type: none"> • Clarification of obligations of financial institutions in respect of AML issues, such as customer identification obligations, record keeping requirements, ensuring originator information is included on all funds transfers; • Providing for the FTRA to override any banking or other secrecy provisions and to clarify the FIU’s investigative power. • Give the FIU power to analyze transactions as well as provide for probity checking for government agencies. • Protection for financial institutions that pass information to the FIU. • Power to enter into Memoranda of Understanding with foreign governments on the exchange of information relating to money laundering. • Expansion of the definition of “financial institution” to include auditors, trust companies and company service providers. • Amend section 10 of the FTRA so as to require customer identification on all account opening and to narrow the exceptional circumstances where identification requirements are waived. • Amend section of the FTRA to expand protection for financial institutions to any information given to the FIU by financial institutions. • Amend section 11 of the FTRA so that records have to be kept for at least five years after the business relationship or transaction has ceased. • Require the VFSC and the auditors to report suspicious transactions. • Include a requirement in the FTRA for a

		<p>compliance officer to be appointed.</p> <p>The Serious Offences (Confiscation of Proceeds) Act was repealed and the Proceeds of Crime Act passed in November 2002. This includes full forfeiture and restraining, monitoring and production powers.</p> <p>The FIU will issue revised guidelines in relation to acceptable identification documents. This guideline will be consistent with the guideline issued by the RBV.</p> <p>Members of the FIU have participated in on-site examinations conducted by the RBV and will continue to do so.</p> <p>The government has agreed to provide additional resources to the FIU.</p> <p>The Extradition Act [CAP 199] was repealed in November 2002 and replaced by the Extradition Act No 16 of 2002. The new Act includes money laundering within the scope of extraditable offences.</p> <p>In addition to the issues identified by the IMF, the Bill for the United Nations Act of 2002 and a Bill for the International Convention for the Suppression of the Financing of Terrorism Act were passed in the November 2002 session of parliament.</p> <p>The FTRA was also amended to include suspicious transaction reporting where financing of terrorism is suspected.</p> <p>The Financing of Terrorism is an offense under the new Proceeds of Crime Act No. 13 of 2002.</p> <p>It has also been recommended to the government that the Criminal Code be amended to make terrorism a crime. The government has accepted this recommendation and amendments will be placed before the next session of parliament.</p> <p>Fit-and-proper guidelines have been issued for domestic and offshore banks and relevant legislation strengthened. Similar criterion will be included in legislation covering trust companies and company service providers.</p>
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