

Republic of Palau: Assessment of the Supervision and Regulation of the Financial Sector—Volume II—Detailed Assessment of Observance of Standards and Codes

This detailed assessment of observance of standards and codes in the financial sector of the **Republic of Palau** in the context of the offshore financial center program contains technical advice and recommendations given by the staff team of the International Monetary Fund in response to the authorities of the **Republic of Palau's** request for technical assistance. It is based on the information available at the time it was completed in **May 2002**. The staff's overall assessment relating to financial sector regulation and supervision can be found in Volume I. The views expressed in these documents are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Palau** or the Executive Board of the IMF.

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



**Volume II: Detailed Assessment of Observance of
Standards and Codes**

Palau

MAY 2002

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I. ASSESSMENT OF OBSERVANCE OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Overview

General

1. This assessment of Palau's observance of the *Basel Core Principles for Effective Banking Supervision* was conducted as part of a Module 2 assessment in the context of the IMF's Offshore Financial Centers (OFC) initiative.

Information and methodology used for assessment

2. The mission relied in its work to a large extent on the relevant legal documents, i.e. laws and draft regulations of the supervisory authority, as well as material provided by the MAE Banking Supervision Advisor assigned to Palau on a peripatetic basis. The mission also had extensive discussions with members of the Palauan government, i.e. the President of the Republic, the Minister of Finance, the Minister of Justice and the Attorney General as well as other government officials including officials of the *Olbiil Era Kelulau* (Congress). The mission met with the Acting Executive Commissioner of the Financial Institutions Commission (FIC), as well as the members of the Governing Board of the FIC.

3. The work of the FIC is in the very early stages. Despite this, the mission sought to make a coherent assessment of the observance of the Basel Core Principles. In cases where a Core Principle is centered on implementation aspects, the mission's assessment of observance includes a qualifier in the "Comments" section to that effect.

Institutional and market structure—overview

4. Palau's financial system consists of 12 commercial banks, including 3 branches of U.S.-based banks, one development bank (the National Development Bank of Palau), 11 non-bank financial institutions, and a number of small credit unions. The three U.S. branches are insured by the FDIC and follow U.S. prudential regulations. One other bank is a branch of an Asian bank, and the remaining eight banks (of which four are controlled by foreign nationals) are locally chartered. Of the 11 non-bank financial institutions, three are reportedly not in operation and eight provide limited financial services. Offshore banking is not allowed in Palau since 1982 when the Offshore Banking Act was repealed. Capital markets are non-existent. No International Business Companies (IBCs) are registered and/or operational in Palau.

5. The largest three U.S.-based banks account for approximately 84 percent of total deposits, with the Bank of Hawaii alone accounting for nearly 57 percent of total deposits. These banks place the majority of their deposits at their headquarters in the United States for investment elsewhere. Most of the local loans are in the form of well-secured consumer loans

rather than business or commercial loans. Foreign banks are prevented by law from acquiring real estate property. The commercial segment of the market has been taken up by the National Development Bank of Palau (NDBP) which guarantees 90 percent of commercial loans; the NDBP can also assume the title of land in case of default. The current size of NDBP's portfolio is about \$7 million, of which one-third is in residential housing. Loans in arrears (so-called "judgment loans") stand at about \$0.7 million, or 10 percent of total loans.

6. Although financial soundness indicators for the banking sector are not being compiled by the authorities as yet, banking operations in Palau are reportedly profitable largely because of the large spread between deposit and lending rates. Deposit rates for the period 1997–2000 on 30-day time savings accounts were in the range 2 ¼–5 percent and on certificates of deposit in the range of 4–8 percent. This compares with lending rates for the same period of between 10–18 percent for consumer loans and 9 ¼–13 percent for commercial loans. Nonperforming customer loans have historically been very low. Data from corporate reports show an aggregate profit for Palau's nine largest banks.

B. General Preconditions for Effective Banking Supervision

7. For historic reasons, the legal system in Palau closely resembles the one of the United States. Owing to the small size of the jurisdiction, local accounting and legal professionals are in a relatively low supply. This is balanced by an important presence of United States' lawyers in both public and private activities. Thus far, financial institutions have followed accounting methods dictated by tax considerations and entered financial transactions on a cash basis. Pursuant to the Financial Institutions Act (FIA) of June 2001, financial institutions will be required to follow Generally Accepted Accounting Principles (GAAP) in the preparation of their balance sheets and income and expense statements.

8. Transparency in the financial market is weakened by deficient rules governing the disclosure of financial statements. As to corporate governance, financial institutions are not required in law to have their balance sheets and income and expense statements audited by reputable external auditors. The FIA provides for receivership of banks in case of insolvency, but no legal safety net, such as a formal deposit insurance system, is envisaged. The U.S. branches operating in Palau are, however, FDIC-insured. They account for some 84 percent of total deposits. In due course, consideration could be given to establishing a deposit insurance system for domestic banks too.

9. At the time of writing, Palau has no central bank nor operational regulatory and supervisory agency. Basic financial legislation was enacted in June 2001 (with assistance from the Pacific Financial Technical Assistance Center (PFTAC) and LEG) in advance of Palau's review by the Financial Action Task Force (FATF). These consisted of the FIA and four anti-money laundering (AML) laws. In approving the FIA, Congress (OEK) substantially changed the provisions for prudential supervision drafted with LEG assistance. This was justified by the authorities as the only way for obtaining the OEK's approval of the Act.

10. The FIA established the Financial Institutions Commission (FIC) as the agency charged with regulation and supervision of banks. The FIA had set forth a deadline, December 17, 2001, on all banks in operation in Palau at the time of the FIA's enactment to apply for a banking license under "grandfathering" provisions. This only meant furnishing the FIC with minimal statutory requirements established in the FIA. The deadline was subsequently extended to February 15, 2002. Twelve banks have submitted the necessary documents by the deadline. The licenses are due to be processed by June 30, 2002.

11. The appointment of an Executive Commissioner and a permanent staff, as well as all the members of the Governing Board has been delayed. The Governing Board was properly instituted on February 21, 2002 with a quorum of the members appointed. This has added to uncertainty as to the starting point of the practical application of all essential provisions in the FIA. The FIA states that the different legal transition periods, ranging from 24 to 48 months, start only after all members of the Governing Board have been elected. As a result, the 12 banks in operation are not currently being subject to any meaningful prudential regulation or supervision for all practical purposes.

12. The main concerns in the FIA that lie in the way of creating an efficient and reliable supervisory structure in Palau are centered around the following issues: the definition of regulatory capital and raising the capital adequacy requirements up to the level of internationally accepted standards; limiting the scope of the banking license depending on the paid-up capital of the bank; instituting the concept of consolidated supervision of all banks; requiring adequate record-keeping, reporting, and auditing for all banks; clarifying the FIC's powers to request additional reports and conduct on-site inspections; and undertaking an initial evaluation of all banks against the new prudential regulations.

13. There is a relatively low level of compliance with the *Basel Core Principles for Effective Banking Supervision*. Palau is compliant with 1 of the Core Principles, largely compliant with 6 and materially non-compliant with 7. The status of legal protection for supervisors has been assessed as compliant, but is subject to an amendment due to be passed by the Congress shortly. Eleven of the principles have been found to be non-compliant even though the work of the FIC was in a very formative phase at the time of the mission as far as the modes and methods of the supervisory regime are concerned. No definite assessment may be made on some of the supervisory arrangements.

Recommendations

14. The FIC's powers to address safety and soundness concerns are curtailed by a provision, (section 61 (c) of the FIA) that sets forth as the primary purpose of the FIC's examinations the disclosure of irregularities and malfeasance in a bank. To enable the FIC to take timely corrective action there should be enacted in the FIA a risk management provision that would give the FIC powers to make a qualitative judgment on a bank's general risk situation.

15. There ought to be clear rules on what kind of investments need supervisory approval and which are subject to notification only. A major consideration in the provisions should be an assessment whether the planned corporate affiliations, both domestic and overseas, would jeopardize the effective supervision of a bank.

16. The legal capital adequacy requirement of 5 percent ought to be raised to conform with the internationally accepted Basel minimum standard of 8 percent. Capital adequacy should be calculated on a consolidated basis. The law should be amended to provide for a more detailed definition of regulatory capital and the risk weighting of different kinds of assets. A breach of the minimum capital adequacy ratio ought to be explicitly stated as grounds for revocation of a license. The FIC should be given the power to take remedial action before a bank experiences a loss of 25 percent or more of its minimum capital requirements.

Principle-by-principle assessment

Table 1. Detailed Assessment of Compliance of the Basel Core Principles

Principle 1.	<p>Objectives, Autonomy, Powers, and Resources An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision; powers to address compliance with laws, as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
Principle 1(1)	<p>An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.</p>
Description	<p>In the preamble to the FIA the OEK has set as a government policy to endeavor to strengthen the economy of Palau by providing measures:</p> <ol style="list-style-type: none"> 1) to protect the interests of consumers of financial services, 2) to prevent systemic risk to the financial system, 3) to provide sufficient scope for market forces to operate in the field of financial services, and 4) to protect the reputation of the Republic in the international financial community. <p>It is also set forth as a goal to establish rules for the licensing, supervision and regulation of financial institutions by the FIC of the Republic of Palau, The law governs both banks and financial institutions operating either in the Republic or under a Palauan license (both domestic and foreign).</p> <p>In section 6 of the FIA it is stated as the FIC’s primary objectives and tasks to ensure the liquidity and solvency of financial institutions in Palau pursuant to the FIA and other regulations, and to provide authorizations to financial institutions as well as to perform supervision and issue regulations.</p> <p>The basic prudential regulations of the FIA concern the capital to risk-weighted assets ratio (5%) and the large exposures ratio (20%/800 %). The implementation of essential parts of the provisions of the FIA is delayed by several years due to the transitional rules of section 77 (b): chapter 4 of the FIA (rules on administrative structure, ownership control, disqualification of management, audit committees and money laundering) only comes into force within two years from the date all of the positions of the Governing Board of the Commission under this</p>

	<p>Act are filled. The transitional period is three years for prudential requirements, and four years for chapter 6 on accounts, financial statements, audit, reporting and examination.</p> <p>Chapter 9 of the FIA contains the provisions on the receivership of banks. The Commission is empowered to determine that a bank is insolvent and therewith revoke the license as well as take possession and control of the bank. In the proceedings the FIC is given advice and represented by the Office of the Attorney General. The receivership and liquidation proceedings are supervised by the Supreme Court's Trial Division.</p> <p>The FIA was passed only in June of 2001. It is the first banking law of its kind in Palau. The OEK is in session four times a year. Some changes to the FIA are expected to be passed in the spring session of 2002.</p> <p>The Governing Board of the FIC must issue an annual report to the President and the OEK. The transparency of the Commission's work is enhanced by a provision according to which all FIC meetings are to be held open to the public unless confidentiality considerations dictate otherwise. The Executive Commissioner shall report at least four times a year to the Commission on the operations and administration of the Commission, on the implementation of supervisory and regulatory policies, and on all financial institutions' compliance with the FIA. The Executive Commissioner shall also report to the Commission of developments that have or may be expected to have a significant effect on the operations of the Commission and on financial institutions. The Commission must also regularly inform the OEK and the public of the analysis it has made on the condition of the financial system, including statistical information on the structure of the financial system.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>The Financial Institutions Commission's work is in a formative phase. The Executive Commissioner of the FIC and the agency's staff have not yet been appointed on a permanent basis. The practical implementation of all essential elements of banking supervision is effectively postponed by several years pending the appointment of all the members of the Governing Board of the Commission.</p>
Principle 1(2)	Each such agency should possess operational independence and adequate resources.
Description	<p>The Governing Board of the FIC consists of six members, five of whom are appointed by the President from among candidates proposed by the Palau Chamber of Commerce. The only grounds for ineligibility are those stated in section 15; no commission member may be a member of the OEK, or of the Council of Chiefs, or while serving as a cabinet member or any other capacity as a government official. The beginning of the effective operations of the FIC has evidently been delayed because of the lack of provisions granting immunity to commission members against lawsuits for the actions they have taken in good faith in their supervisory work.</p> <p>A majority of the appointed members of the Commission must be citizens of Palau; all Commission members must be persons of recognized integrity and professional experience in economics or finance or in legal matters related to the functions of the Commission; there must be no ground for removal applicable to them under section 17 applies.</p> <p>The permanent Executive Commissioner of the FIC is expected to be appointed in October 2002. Unlike other heads of government agencies, the Executive Commissioner is appointed and dismissed by the Governing Board. The appointment of the Executive Commissioner by the Governing Board that represents largely the banking industry and the business community also detracts from the operational independence of the supervisory authority. All powers that are not vested in the Executive Commissioner are in the domain of the Governing Board. The main duties of the Executive Commissioner are described as implementing the decisions of the Governing Board, and to manage and organize the work of the FIC.</p> <p>All external auditors utilized by the Commission must be certified public accountants with at least five years' experience auditing banks. All independent bank examiners utilized by the Commission must be certified public accountants and have five years' experience examining banks.</p>

	<p>Section 61 of the FIA contains a provision against attempt to harass, intimidate, or exert undue influence on an examiner of the Commission or the auditors appointed by it.</p> <p>The FIC's budget must be proposed and submitted to the OEK. At the time of the mission it was indicated that the government would be prepared to provide funds to start up the operations of the FIC. According to the FIA, the Commission is to charge fees to financial institutions for its supervisory and regulatory services that are to defray its costs. Fees are set for each bank in relation to their assets or to extraordinary expenses incurred by the Commission or its agents in supervisory work. The annual fees to banks for ordinary supervision and regulation may not exceed 0.25% of a bank's assets or \$5,000 whichever is less. The annual fees are to be paid by year-end for the next calendar year.</p> <p>The budget proposal for April to September 2002 includes initial start-up costs of \$36,000 and recurring costs for the first six month of about \$55,000. The FIC has still to rent its office space and buy its equipment.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>The operational independence of the supervisory authority may be affected as the budget of the FIC has to be submitted to the OEK. The legal provision of section 12(a)(2) bears clarification as to whether the OEK has powers to revise the FIC's budget.</p> <p>The voting members of the Board of the FIC are appointed by the President of Palau from among candidates proposed by the Palau Chamber of Commerce. The banking industry is thus given a dominant role in the selection process. One of the five voting members of the commission was still not appointed. The provision barring government employees from being members of the Governing Board of the FIC has also complicated the selection of commission members. The beginning of the effective operations of the FIC is deemed to have been delayed because of the lacking provisions concerning the legal immunity of commission members and members of staff.</p> <p>The appointment of the Executive Commissioner by the Governing Board that represents largely the banking industry and the business community also detracts from the operational independence of the supervisory authority. The independence is materially undermined by the legal provision giving the OEK powers to prevent the issuance of the prudential regulations that the FIC is to issue as delegated in the FIA.</p> <p>The role of the Governing Board in the decision making process is predominant due to FIA provisions; in the initial phases it is also strengthened due to the fact that the post of the Executive Commissioner is filled on a caretaker basis.</p>
Principle 1(3)	A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>The FIC's powers as to licensing banks are stipulated in a specific chapter of the FIA. According to section 61 of the FIA, all financial institutions are obligated to co-operate with the examiners of the Commission or auditors appointed by the Commission.</p> <p>In the transitional provisions of chapter 12 of the FIA it is stated that the FIC is empowered to issue such regulations, orders, or guidance, to visit the offices of financial institutions, and to examine their accounts, books, documents and other records as the FIC deems necessary or advisable considering the provisions of the FIA. However, the regulations issued by the FIC are promulgated according to the Administrative Procedure Act, with the proviso that no proposed regulations can become effective without approval of the OKE by joint resolution of both chambers. According to the same act, a copy of a regulation is to be submitted to the President of the Republic. The President may approve or disapprove the rule within 20 days.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	The FIC's independent regulatory powers are effectively limited by the fact that the FIC's regulations only take effect after the OEK as well as the President have approved them.
Principle 1(4)	A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.

Description	<p>The FIC has access to a bank’s offices and a right to examine their accounts, books, documents and other records as the FIC deems necessary (section 78). However, according to section 61(c), the FIC cannot be deemed to have powers to address the safety and soundness concerns of a bank. The primary purpose of an audit or examination is to inform the Commission about fraudulent acts within a bank or any irregularity or deficiency in the bank's administration or operations that may result in a material loss for the bank or a subsidiary.</p> <p>Section 62 contains a provision on the FIC’s powers to address non-compliance of laws and regulations. The FIC can inter alia issue written warnings; conclude a written agreement with a bank on a program of remedial action; or issue cease and desist orders, subject to approval of the Supreme Court for issuance of cease and desist orders.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>The FIC’s powers to address compliance and to apply judgments on banks’ performance are largely untested. The primary purpose of bank examinations is not to form a view of a bank’s general risk situation but to learn of wrong doings in a bank. The FIC’s independent powers are curtailed by it having to seek Supreme Court confirmation for the issuance of cease and desist orders.</p>
Principle 1(5)	
A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.	
Description	<p>According to Palau officials, an amendment to the FIA is to be adopted by the OEK in the spring session of 2002. The contents of the original bill for the FIA are going to be incorporated in law during the Spring session of the OEK. In a court proceeding, commission members, officers, employees and agents of the Commission can only be convicted for their supervisory activities if the person has acted in an arbitrary or capricious manner. The person is liable for damages or liable for acts or omissions if intentional wrongful conduct has been in evidence. The above persons enjoy in all other respects immunity for any act or omission in the course of their duties and responsibilities.</p> <p>The present law includes a provision against attempts to harass, intimidate, or exert undue influence on an examiner of the Commission or the auditors appointed by it. Complaints may be made against such actions.</p> <p>The legal costs that supervisory personnel has incurred in defending their cases are born by the Attorney General’s Office.</p>
Assessment	COMPLIANT
Comments	<p>At the time of the mission, the present wording of law was found to be non-compliant with the principle of legal immunity. The assessment “compliant” is subject to the OEK adopting during the spring session the amendment to the FIA that was presented to the mission.</p>
Principle 1(6)	
Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.	
Description	<p>The Commission is required to cooperate with public authorities in pursuing its objectives, and by law it must also take action to promote such cooperation.. The Commission shall provide general information, unless constrained by the confidentiality and secrecy provisions of the FIA, if requested by the Ministry of Finance or other government agencies.</p> <p>By law the FIC is the official agency for information as to the status of any bank or other financial institution licensed in Palau. The Commission is authorized to the extent set forth in law to cooperate and exchange information with foreign government and international agencies.</p> <p>According to section 24 of the FIA, no past or present member of the Commission or FIC staff or an auditor or agent appointed by the Commission may unless authorized by law permit access to, disclose or publicize nonpublic confidential information which was obtained in the performance of his or her duties for the Commission; or use such information, or allow such information to be used, for personal gain. All information derived in supervisory work in the possession of the FIC is to be kept confidential unless authorized by the person to whom it relates or required by law or a court order.</p>

Assessment	LARGELY COMPLIANT
Comments	The law does not provide clear rules on information sharing. No memoranda of understanding have been established with foreign supervisory authorities.
Principle 2.	Permissible Activities The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.
Description	<p>The FIA is applied to banks, securities brokers, and securities dealers (“financial institutions”), their shareholders, administrators, employees, agents and affiliated entities, and applicants for bank credit. A bank is defined as a person engaged in the business of accepting deposits in the Republic of Palau from residents and non-residents and using such funds to make extensions of credit or investments for the account of and at the risk of the person carrying on the business, including branches of banks organized in other jurisdictions.</p> <p>"Deposit" means a sum of money paid on such terms that it is to be repaid in full, with or without interest or premium of any kind, and either on demand or at a time agreed by or on behalf of the person making the payment and the person receiving it; and it is not referable to the provision of property or services or the giving of security. The deposit may or may not be evidenced by any entry in a record of the person receiving the sum, or by any receipt, certificate, note or other document.</p> <p>According to section 51 of the FIA, banks are authorized to engage in the following activities:</p> <ol style="list-style-type: none"> (1) receiving deposits; (2) buying and selling for a bank’s own account debt securities issued or guaranteed by the Government of Palau or by governments or central banks of G-10 or European Union countries that are denominated and payable in Dollars with a maturity not exceeding one year; (3) payment and collection services; (4) issuing and administering e.g. payment cards, travelers' checks and bankers' drafts; (5) buying and selling foreign exchange for cash for the account of the bank and a customer; (6) safekeeping of securities and other valuables; and (7) receiving deposits in more than one currency; (8) extending credit to enterprises, including, factoring with or without recourse; (9) borrowing funds and buying and selling for a bank’s own account or for the account of customers (excluding underwriting) of money market instruments; debt securities; futures and options relating to debt securities or interest rates; or interest rate instruments. (10) money brokering; (11) financial leasing; (12) credit reference services; (13) providing services as a financial agent or consultant (not including deposit taking and debt securities); (14) dealing in foreign exchange; (15) trust services, including, the investment and administration of funds received in trust and administration of securities; (16) services as an investment portfolio manager or investment adviser; (17) underwriting and distribution of debt and equity securities and brokering and dealing in equity securities. <p>According to section 53 (d) of the FIA, it is explicitly prohibited for a bank to engage directly in industry, commerce, or other non-financial services in the Republic of Palau. The application of the limitations on permissible activities are, however, effectively postponed by three years by virtue of the provision requiring the appointment of all Commission members,</p>

	<p>FIA section 77 (b).</p> <p>The range of activities a bank is entitled to be engaged in is not limited by any considerations as to the level of the bank's regulatory capital.</p> <p>According to section 3 of the FIA, no person shall use the words "bank," "trust," "trust company," or "financial corporation" or derivatives of these words in respect of a business, product, or service without being licensed to operate as a bank. Such usage may, however, be established or recognized by law or international agreement, or it shall be clear from the context in which the words "bank," "trust," "trust company," or "financial corporation" are used that it does not concern financial activities. Any person who violates these provisions is subjected to the sanctions of section 62.</p>
<p>Assessment</p>	<p>COMPLIANT</p>
<p>Comments</p>	<p>The definitions for a bank and financial institution are in place. However, banks existing before the enactment of the FIA are by law allowed to engage in non-financial activities for a transitional period of three years. There are no provisions that would limit the scope of a bank's permissible activities depending on the amount of its capital base.</p>
<p>Principle 3.</p>	<p>Licensing Criteria</p> <p>The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
<p>Description</p>	<p>According to section 32 of the FIA, new banks need to apply for a license to the FIC. An application must be accompanied by documentation concerning the qualification and experience of each member of the management of a bank with a CV for the past 10 years, the amount of the capital of the new institution; a business plan including projected financial statements for three years; a business and professional history for the past three years of a principal shareholder (more than a 10 % stake) and the balance sheet and profit and loss statement for the most recent fiscal year. The Commission may require supplemental information.</p> <p>A license may only be approved if the business plan is based on reasonable assumptions demonstrating that the bank will become profitable within a reasonable time; the bank will comply with all provisions of the FIA and that the experience and integrity of management as well as the capitalization are appropriate to the business plan and the activities it is going to pursue.</p> <p>The FIC may impose conditions on a license concerning the payment of the capital; the hiring and training of staff; the lease or purchase of equipment and the establishment of operations systems, including internal audit and controls; the lease or purchase of business premises; and the engagement of an auditor or chief accountant. A bank has to comply within one year with the conditions set. If upon an on-site inspection of the applicant's premises, the FIC finds that the conditions have been met, the FIC issues an approval for a bank to commence operations.</p> <p>The new FIA came into force on June 18, 2001. According to section 30 on the licensing of existing banks (EFIs), at the time of the FIA's promulgation, had a 180 day transitional period within which the banks had to provide the FIC with only minor statements, ie. a copy of the bank's charter and a certificate of good standing from the Registrar Authority. The banks are under the grandfathering provision licensed to engage in all the permissible activities regardless of whether they have been engaged in them before the FIA. The existing banks were deemed to be in full compliance of the legal conditions for a banking license. Due to the belated commencing of the FIC's operations, the EFI's licenses are expected to be acted upon by June 30, 2002, at the earliest. At the time of the mission they are only equipped with a business license from the Tax Office.</p>

	<p>Section 36 of the FIA states that a bank’s license can be revoked on specified grounds, most importantly, that the license has been obtained on the basis of false information or that another financial institution that holds a significant interest in the bank has had its license revoked.</p> <p>The minimum capital for new licensees is either \$500,000 (Palau banks) or \$5,000,000 (foreign bank subsidiaries in Palau). The consolidated capital of the foreign parent bank for a Palau subsidiary or branch may not be less than \$75,000,000.</p> <p>The FIA’s chapter 4 contains provisions on corporate governance, i.e., charters and instituting of audit committees. The banks existing at the time of the FIA’s promulgation have a two-year interim period within which to comply with the FIA.</p> <p>A license for a branch or a subsidiary of a foreign bank can be issued only on the condition that the bank is authorized to engage in the business of receiving money deposits or other repayable funds in the jurisdiction or foreign country where its head office is located; the competent authorities that supervise the financial activities at the head office of the foreign bank have given their written consent to the granting of such license; and the Commission has been able to determine that the foreign bank is adequately supervised on a consolidated basis by the home country supervisory authorities (section 33).</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>The banks existing when the FIA was passed have not been required to undergo the proper licensing process. Only marginal information has been furnished to authorities, i.e. a registrar certificate on the institution’s bank status and good standing. The EFIs were categorically deemed to fulfill all prudential requirements of the FIA at the time of the enactment of the law. The law provides ample time for all banks to fulfill the prudential requirements.</p> <p>The FIC’s powers to require supervisory reports on the standards during the interim period need to be clarified. The supervisor lacks powers to require banks to furnish practical plans as to maintaining an adequate level of capital and profitability. There is no provision that would require the conditions for a bank’s license to be fulfilled at all times.</p> <p>There are no detailed licensing guidelines concerning, e.g., “fit and proper” tests, and the operational policies, and internal control procedures of the applicant.</p>
Principle 4.	<p>Ownership Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.</p>
Description	<p>Significant interest is defined as a direct or indirect holding of an interest in a person or undertaking that is at least 20% of the equity or of any class of shares with voting rights, or that makes it possible to exercise a significant influence over the management or policies of that person or undertaking.</p> <p>In order to be become legally effective, the transfer of an equity interest in a Palau financial institution requires prior authorization of the Commission if any person or a number of persons acting in concert would, directly or indirectly, hold a significant interest in such financial institution. The qualifications, experience, and integrity of the proposed shareholders must be held appropriate in relation to their significant ownership of the financial institution.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>Changes in ownership of banks are to be reported to the FIC. No regular reporting arrangements on the beneficial owners of banks have been instituted. The technical assistance program prepared by the MAE Banking Supervision Advisor includes plans to develop regulations requiring existing banks to provide information on beneficial owners.</p>
Principle 5.	<p>Investment Criteria Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>

Description	<p>No provisions have been given on what types of acquisitions need supervisory approval or need to be notified to the supervisor. No risk elements are taken into account in the regulations.</p> <p>According to section 40 of the FIA, no domestic bank may alone or in concert with one or more other persons, directly or indirectly hold an equity interest in an undertaking that is engaged in other than financial activities that either represents a significant interest (20%) or exceeds as to its net current value the equivalent of fifteen percent (15%) of the bank's capital. The aggregate net current value of all such equity interests may not exceed the equivalent of fifty percent (50%) of the bank's capital. No authorization is required for equity interests that have been acquired in lieu of repayment of credit granted by the bank. A bank shall entirely dispose of such equity interests within one year from the date they are acquired or within a longer time period that the Commission may grant, not exceeding two years. Equity interests held as an agent are also excluded.</p> <p>According to section 53(b) of the FIA, banks must observe the regulations the Commission may issue concerning the maximum aggregate amount of real estate investments.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>No legal provisions are in place for defining which investments need supervisory approval. The supervisor has no powers to prevent corporate affiliations from coming about that would prevent effective supervision.</p>
Principle 6.	<p>Capital Adequacy Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.</p>
Description	<p>According to Section 53 of the FIA, the capital adequacy ratio of a bank concerning its assets, risk-weighted assets, and off-balance-sheet items shall not be less than five percent (5%). No regulations have been issued on the definition of regulatory capital, risk based capital and risk-weighted assets. In the technical assistance program prepared by the MAE Banking Supervision Advisor it is envisaged that clearer prudential guidelines are to be issued in the last quarter of 2002.</p> <p>The capital adequacy rule of the FIA does not provide for the application of the ratio on a consolidated basis nor for regular reporting to the supervisor.</p> <p>For Palau banks, i.e., excluding foreign bank subsidiaries, whose capital is than three-quarters of the required minimum capital of \$500,000, the Commission shall require the bank to adopt a satisfactory capital restoration plan that requires the bank to attain capital adequacy within six months from the determination by the Commission. Banks existing before the enactment of the FIA are exempt from the minimum capital requirements.</p>
Assessment	NON-COMPLIANT
Comments	<p>The legal capital adequacy requirement of 5% does not conform to the internationally accepted minimum standard of 8%. No regulations are in existence concerning the definition of regulatory capital or regular prudential reporting. The law provides an exemption to the so-called EFI's from the rule of the minimum absolute amount of regulatory capital. A breach of the minimum capital adequacy ratio is not explicitly stated as grounds for revocation of a license. Any violation of a FIA provision in itself is, however, subject to an action or a remedial measure by the FIC. The FIC may take action on a weakening of the capital base only after 25% of the minimum amount has been lost.</p>
Principle 7.	<p>Credit Policies An essential part of any supervisory system is the independent evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.</p>
Description	<p>The FIA article on the obligatory Risk Management Committee provides the banks with an elementary institutional framework for formulating credit policies and procedures.</p>
Assessment	NON-COMPLIANT

Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite assessment may be made on the supervisory arrangements.
Principle 8.	Loan Evaluation and Loan-Loss Provisioning Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves.
Description	<p>The FIA gives the FIC powers to issue regulations concerning the classification and evaluation of assets and provisions to be made on the basis of such classification and evaluation against substandard and non-performing loans, and the time when earnings on non-performing loans may no longer be accounted for as income except as received in cash.</p> <p>The Risk Management Committee obligatory to all Palau banks has to establish policies and procedures for approval of large credits, requirements for collateral for credit, classification of and provisioning for value-impaired assets, as well as pursuit of borrowers and issuers in default. In the technical assistance's recommended work program (TA) for 2002 it is scheduled to have regulations instituted within the third quarter on asset classification, minimum provisioning and credits on non-accrual basis.</p>
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. Nevertheless, the supervisor has not issued regulations on asset classification, loan loss provisioning and reporting of substandard loans. The supervisor also lacks powers to require a bank to strengthen its lending practices and level of provisions.
Principle 9.	Large Exposure Limits Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
Description	<p>According to section 53(a)(2) and (3) the maximum aggregate amount of credits that a bank is permitted to have committed or outstanding to any single person or group of interrelated persons may not exceed twenty percent (20%) of its capital; the aggregate amount of credits that exceed ten percent (10%) of a bank's capital shall not exceed eight hundred percent (800%) of a bank's capital. The transitional period of three years is applicable to these rules.</p> <p>There are no legal provisions or regulations on the way different types of credit and contingent liabilities are to be included in the calculation. The concept of a group of interrelated clients is not defined. The large exposure regulations are not applied on a consolidated basis. No reporting arrangements are in place, e.g., as to the size of exposure that have to be reported.</p> <p>In the TA for 2002 it is planned to have regulations concerning reporting and calculation of large credits incorporated within the third quarter of 2002.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	There are not specific regulations in place for the calculation of large exposures and the regular reporting of such exposures.
Principle 10.	Connected Lending In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
Description	<p>The definition of connected parties is as follows: members of management (administrator), significant shareholders, persons who are related to such administrator or significant shareholder by marriage, consanguinity to the second degree, or business interest; legal persons that have a significant interest in a person in which the bank has a significant interest.</p> <p>The FIC may give further regulations concerning credit extended by a Palau bank to any related financial institution. A related bank or financial institution is defined as any financial institution in which the bank holds a significant interest.</p>

	<p>According to section 56 on transactions with related persons, Palau banks may not enter into a transaction with or for the benefit of related persons of the bank, if such transaction is entered into on more favorable terms and conditions than for the benefit of persons who are not so related to the bank.</p> <p>A member of management or the board who has a material interest is obligated to leave a meeting where a contract is discussed and must refrain from voting. An interest is material (section 49(c)) if it is material with reference to the wealth, business, or family interests. A material interest also comes about through the person owning a significant interest in a company, or being an administrator in a company or a partner in a partnership. If a material conflict of interest has been left undisclosed a court may, on the application of the Commission, the bank or a shareholder, set aside the contract.</p> <p>No Palau bank shall extend credit to a person related to the bank if as a result the aggregate amount outstanding on all credits extended by the bank to any such person would exceed twenty percent (20%) of a bank's capital; or the aggregate amount of credits to all persons so related to the bank would exceed one hundred percent (100%) of the bank's capital.</p>
Assessment	LARGELY COMPLIANT
Comments	A definition for a connected party is in place as well as requirements on arms length lending. No procedural rules have been enacted concerning decision-making, reporting, or information systems. The application of the provisions is limited to Palau banks.
Principle 11.	Country Risk Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
Description	There are no legal provisions or regulations in existence concerning country or transfer risk. The Risk Management Committee that each Palau bank has to establish shall establish and monitor implementation of policies and procedures for country risk. There is no supervisory experience in this area.
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite comment may be made on this supervisory arrangement.
Principle 12.	Market Risks Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.
Description	There are no detailed legal provisions or regulations in existence concerning market risks. There is no supervisory experience in this area. According to the FIA the FIC may issue regulations concerning requirements for the minimum aggregate amount of liquid assets or specific categories of assets in relation to the amount of liabilities or specific categories of liabilities. The FIA also allows for regulations with possible prohibitions, restrictions, or conditions concerning matching of assets and liabilities as to maturity and interest rate; and unhedged positions in foreign currencies, precious metals, or precious stones. The Risk Management Committee that each Palau bank has to establish according to section 46 of the FIA shall establish and monitor implementation of policies and procedures for managing interest rate and market risk.
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite comment may be made on this supervisory arrangement.
Principle 13.	Other Risks Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.

Description	<p>According to section 46(c), all Palau banks are to have a Risk Management Committee established. The committee must consist of three members of the board of directors for a term not to exceed two years. The committee must (1) establish and monitor implementation of policies and procedures for credit appraisal, loan administration, and asset and liability management, e.g. matters as underwriting standards, approval of large extensions of credit and all equity investments, requirements for collateral for credit, classification of and provisioning for value-impaired assets, pursuit of borrowers and issuers in default, and managing interest rate, market, and country risk; (2) monitor compliance with the laws and regulations applicable to credit and other risks and report to the board of directors; and (3) deliver opinions to the board of directors. The Risk Management Committee must meet at least once per month, according to the FIA. Additionally, banks may establish separate Credit and Asset and Liability Management Committees.</p>
Assessment	NON-COMPLIANT
Comments	<p>The work of the FIC was in a very formative phase at the time of the mission. No definite assessment may be made on the supervisory arrangements.</p>
Principle 14.	<p>Internal Control and Audit Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.</p>
Description	<p>Section 43 of the FIA states that the Board of Directors are responsible for establishing the policies for the operations of the bank and for the supervision of their implementation. The Board has to have five to nine members; the majority may not be members of management. Board members are appointed by the shareholders for a maximum period of four years. The board or its members may not delegate their responsibilities to others.</p> <p>All persons elected or appointed as administrators (members of management) of a financial institution must be of good repute and must meet the criteria established by a regulation of the Commission regarding qualifications, experience, and integrity.</p> <p>Section 45 of the FIA states that a person is not eligible to become a member of the board of directors of a Palau bank, or can be dismissed from the board by the general or special meeting of shareholders, in the event that:</p> <ol style="list-style-type: none"> (1) a person has been deprived by a court or regulatory body of competent jurisdiction of the right to sit on the governing body of a corporation or other legal person; (2) a person serves, or has served at any time during the immediately preceding twelve-month period, on the administrative body of the Commission; (3) a person has been convicted of a felony or a crime of moral turpitude; (4) the Commission determines that a person has been a party to a transaction that violates this Act; or (5) a person has been issued a final judgment for non-payment of a debt which has not been paid in full or is in arrears of payment under a court order or has been an administrator of an entity that has been liquidated because of insolvency. <p>The FIC may also relieve a board member of his or her duties if the shareholders fail to act within thirty days of notice of the disqualification.</p> <p>There is no explicit requirement in the FIA to establish an independent audit function in a bank. In the TA program it is scheduled that there is in the later stages of the project development and issuance of guidelines on minimum criteria to evaluate the adequacy of a banks internal audit procedures.</p> <p>Each Palau financial institution shall establish an Audit Committee that consists of three members appointed by the board for periods of up to two years. Grounds for eligibility are</p>

	the same as those for members of the board. The Audit Committees duties include, inter alia, establishing appropriate accounting procedures and controls, supervising compliance, and recommending to the board of directors the appointment of internal or external auditors; monitoring compliance with the FIA and laws and regulations applicable to the Palau financial institution and reporting to the board of directors thereon; making recommendations to the bank's board of directors to engage outside experts to assist the Audit committee; and giving consultation to the board of directors. The Audit Committee is to meet at least once per quarter.
Assessment	LARGELY COMPLIANT
Comments	The role of the board of directors is defined in a largely satisfactory manner. On a legal basis, the supervisor can have influence on the appointment of board members. The internal audit committee is obligatory by law but the establishment of the internal audit function and the organization of the internal audit function are left to the discretion of the bank's board of directors.
Principle 15.	Money Laundering Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.
Description	<p>According to section 13 of the Money Laundering Act (MLA), banks must have written policies and procedures for the prevention of money laundering. The programs shall address the following subjects: (a) centralization of information on the identity of customers, principals, beneficiaries, authorized agents, beneficial owners, and suspicious transactions; (b) designation of compliance officers, at central management level, in each branch and at each agency or local office; (c) on-going training for officials or employees; and (d) internal audit arrangements to check compliance.</p> <p>According to section 8 of the MLA, casual customers shall be identified, in the manner specified more closely in the MLA, in the case of transactions involving a sum greater than the equivalent of \$10,000. Even the customer with smaller transactions are to be identified if there seems to be within a reasonable doubt an unlawful purpose. Banks are required to identify also the beneficial owners if it is uncertain whether a customer is acting on his or her own behalf.</p> <p>Section 11 of the MLA provides that banks maintain and hold at the disposal of the authorities records and customer identification for five years after the account has been closed or the customer relationship has ended. In the case of cases that have to be reported to the Financial Intelligence Unit (FIU), the records have to maintained for 10 years.</p> <p>Banks are to report to the FIU and the Attorney General transactions larger than \$10,000 if they are conducted in a manner than appears to have an unlawful purpose. The origin and destination of the money, the purpose of the transaction, as well as the identity of the transacting parties. Transactions smaller than the above sum are also to be reported to the FIU if there reasonably appears to be an unlawful purpose.</p> <p>In section 19 of the MLA a reporting requirement is set on all natural or legal persons who, in connection with their trade or occupation, carry out or advise on operations involving deposits, exchange operations, investments, conversions, or any other movements of capital, and in particular to credit and financial institutions are required to report to the FIU transactions involving money that reasonably appears to be derived from the perpetration of a money laundering crime. Reports must be made of the transactions carried out even if it was not feasible to defer their execution or if it became clear only after completion of a transaction that it involved a money laundering offense.</p> <p>Section 21 of the MLA provides for exemption from liability for bona fide reporting of suspicions. No judicial proceeding for breach of banking or professional secrecy may be instituted against a person who in good faith has carried out a transaction which later is determined to be a suspect transaction or money laundering offense or has transmitted information or submitted a report to authorities according to the MLA. No civil or criminal action may be brought, nor any professional sanction taken, against a person who in good faith</p>

	<p>transmits information or submits reports pursuant to this Act, even if the investigation or judicial decision do not give lead to a charge for any offense. Additionally, no civil or criminal action may be brought against any person by reason of any material or non-material loss or economic or non-economic damage of any kind resulting from the freezing of a transaction or the reporting of suspicious transactions or possible violations or other wrongdoing according to the MLA.</p> <p>Section 48 the FIA includes a provision according to which no financial institution shall conceal, convert, or transfer cash or other property, knowing that such property is derived from criminal activity, for the purpose of concealing or disguising the illegal origin of the property or shall knowingly assist any person who is involved in such activity to evade the legal consequences of his or her action. Money laundering is defined in the MLA as the conversion or transfer of property for the purpose of concealing or disguising the illegal origin of such property; or the concealment or disguise of the illegal nature, source, location, disposition, movement, or ownership of property; or the acquisition, possession, or control of property by any person who knows that the property constitutes the proceeds of crime as defined herein.</p> <p>Natural persons convicted of money laundering may be fined at least \$5,000 or imprisoned for up to ten years. Corporate entities may be fined for up to two times the fines for natural persons. Corporate entities which are convicted of three or more offenses within a five-year period, such entities may be, e.g., permanently or for a maximum of five years banned from directly or indirectly carrying on the business activities Palau for which they are licensed or conducted at the time of the offense; or ordered to close permanently or for a maximum of five years their premises which were used for the commission of the offense. Civil penalties may also be given to natural persons on the application of the Attorney General's Office. There are also provisions on the confiscation of property and proceeds</p> <p>The FIU is situated within the Office of the Attorney General. Other agencies of the government may be assigned to assist the FIU by the President at the request of the Attorney General. An annual report shall be submitted by the FIU to the President, the Minister of Justice, and the OEK. The report shall provide an overall analysis and evaluation of the reports received and of money laundering trends.</p> <p>According to section 7 of the FIA, the FIC shall provide general information as limited by the confidentiality and secrecy provisions of this Act as requested from time to time by the Ministry of Administration or other government agencies as may be necessary for the performance of its duties.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>There are no FIC or FIU guidelines on what may constitute a potentially suspicious transaction. The FIC has no explicit legal obligation to report suspicious transactions to the FIU or to share with judicial authorities information related to criminal activities. There are no regulations under the MLA governing its implementation.</p>
Principle 16.	<p>Onsite and Offsite Supervision An effective banking supervisory system should consist of some form of both onsite and offsite supervision.</p>
Description	<p>Section 61 of the FIA states that all Palau financial institutions and their Palau subsidiaries and Palau branches of foreign banks shall cooperate with the examiners of the Commission and any auditors appointed by the Commission.</p> <p>According to section 24 of the FIA, no member of the Commission or FIC staff or an auditor or agent appointed by the Commission may unless authorized by law permit access to, disclose or publicize nonpublic confidential information which was obtained in the performance of his or her duties for the Commission; or use such information, or allow such information to be used, for personal gain. All information derived in supervisory work in the possession of the FIC is to be kept confidential unless authorized by the person to whom it relates or required by law or a court order.</p>
Assessment	NON-COMPLIANT
Comments	<p>The work of the FIC was in a very formative phase at the time of the mission. No</p>

	definite assessment may be made on the supervisory arrangements.
Principle 17.	Bank Management Contact Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.
Description	The supervisor has not powers to require a bank to make a notification of substantive changes in its activities or material adverse developments.
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite assessment may be made on the supervisory arrangements.
Principle 18.	Offsite Supervision Banking supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
Description	<p>According to section 26 of the FIA, the Commission collects statistical and related information to fulfill its duties. The law does not provide the supervisor with general powers to require information from banks. According to section 26(b), the Commission has to issue regulations on the information that must be submitted to it. As stated in CP1(3), the independence of the FIC in issuing regulations is compromised by the power of approval that is accorded to the OEK. The law does not require off-site reporting to be produced on a consolidated basis.</p> <p>No regular reporting arrangements had been implemented at the time of the mission to Palau. The TA for 2002 calls for development of off-site monitoring procedures and responsibilities, preparation of off-site monitoring summary reports, recommendations for addressing noted weaknesses and areas of concern. Key ratios are to be identified regarding capital adequacy, asset quality, earnings performance and liquidity to assess condition of banks and overall banking industry. The MAE Advisor is also due to assist in the establishment and development of a database for the maintenance of current and historical (level and trends) statistical data and the automated calculation of key ratios and selected levels and trends. Draft reporting formats and schedules for banks to be used in submission of data have been prepared by the MAE Advisor and are being considered by the FIC. It is also projected to provide hands-on training to FIC staff to conduct analyses of banks' condition, operating performance with emphasis on using key ratios and trends. Toward the end of 2002, guidelines are expected to be developed on the rating of banks, e.g. the CAMELS model and establishment of benchmarks to make appraisals of banks' condition.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. Regardless of that an assessment can be made based upon the fact that the FIC is lacking explicit powers to require any information it needs for supervisory purposes. The FIC is in the process of establishing a framework of standardized prudential and statistical reports.
Principle 19.	Validation of Supervisory Information Banking supervisors must have a means of independent validation of supervisory information either through onsite examinations or use of external auditors.
Description	<p>According to section 61 of the FIA, all external auditors utilized by the Commission must be certified public accountants with at least five years' experience in auditing of banks. Independent bank examiners utilized by the Commission must be certified public accountants with at least five years' experience examining banks. Any intimidation tactic or harassment used against a financial institution by such auditors or examiners may be made the subject of a complaint.</p> <p>According to law, the primary purpose of an audit or examination is to inform the Commission about fraudulent acts by bank employees or any irregularity or deficiency in the bank's administration or operations that should be expected to result in a material loss for the bank or a subsidiary.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	The supervisory powers to perform on-site examinations are stated in law. They are,

	however, somewhat hampered by the provision stating as the primary purpose of any examination the disclosure of fraudulent acts or deficiencies or irregularities in a bank's administration. Domestic banks are exempt from the requirement to have their annual financial statement audited by an external auditor.
Principle 20.	Consolidated Supervision An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.
Description	No provisions are in place on the consolidated supervision of Palau banks. The only reference to consolidation concerns the application of certain provisions, e.g. prudential standards, to the branches of foreign banks on a consolidated basis.
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite comment may be made on this supervisory arrangement.
Principle 21.	Accounting Standards Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.
Description	<p>According to the FIA a bank's board of directors is responsible for establishing the policies for the operations of the bank and for the supervision of their implementation.</p> <p>According to section 57 of the FIA, financial institutions shall maintain at all times accounts and records and prepare annual financial statements adequate to reflect their operations and financial condition in accordance with consistently maintained Generally Accepted Accounting Principles (GAAP) promulgated by the Financial Accounting Standards Board or other generally accepted accounting standards approved by the Commission.</p> <p>The accounts, records, and financial statements of a foreign bank shall reflect the operations and financial condition of its subsidiaries and Palau branch offices, on an individual and consolidated basis. The FIA does not require Palau banks to draw up consolidated accounts.</p> <p>At the end of each calendar year, each Palau bank shall internally <u>or</u> externally audit itself and produce an annual financial statement which shall present a full and fair view of the financial condition of the Palau bank.</p> <p>Section 58 of the FIA requires that at the end of each calendar year, each foreign bank shall produce financial statements prepared by a licensed certified public accounting firm which shall present a full and fair view of the financial condition of the bank.</p> <p>The audit will be presented to the Commission on June 30 for the previous calendar year. The Commission shall review each internal audit and if good cause can be shown require that any financial institution submit additional information either on site or off site or, in the alternative, submit to an off site evaluation by either an independent external auditor or independent bank examiner. Additionally, the Commission or the external auditor or examiners may request additional reports and information. This is, however subject to the FIC being able to show a good cause for information needs. Supplemental reports and information shall only be requested for bona fide reasons and not to intimidate or harass any financial institution. All external auditors utilized by the Commission must be certified public accountants, with at least five years' experience auditing banks. All independent bank examiners utilized by the Commission must be certified public accountants and have five years' experience examining banks.</p> <p>According to section 59 of the FIA each Palau financial institution shall annually by June 30 provide the Commission with a balance sheet for the financial institution as of December 31 of the previous year. Branches of foreign banks must make available to the public their annual audited reports on a consolidated basis.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	The law exempts Palau banks from the obligation to disclose their financial statements.

	<p>Only branches of foreign banks have to make their audited accounts public. As a further discrepancy in the legal provisions between domestic and foreign banks, only foreign banks have to employ external auditors. Given the facts above, it still needs to be noted that the supervisor has no powers to revoke the appointment of an auditor; auditors have no legal obligation to report to the FIC, e.g. of material events or violations of banking law.</p>
<p>Principle 22.</p>	<p>Remedial Measures Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.</p>
<p>Description</p>	<p>“Remedial action” means measures to correct the infractions described in section 62 which may include: (1) the establishment of a plan to increase capital to achieve compliance with this Act; (2) the establishment of new committees of the financial institution to oversee credit administration, asset and liability management, or internal audit and controls; (3) replacement of the heads of departments; or (4) establishing and enforcing internal controls.</p> <p>According to section 62 of the FIA, the remedial measures and penalties provided for infractions are determined in individual cases by the Commission and shall be imposed subject to the provisions of the Administrative Procedure Act, 6 PNC Chapter 1.</p> <p>The Commission must take action or impose penalties with respect to a financial institution if it determines that the financial institution or any of its administrators or principal shareholders is guilty of the violation of a provision of FIA or of a regulation or order of the Commission or the violation of any condition or restriction attached to an authorization issued by the Commission.</p> <p>The Commission can issue written warnings; conclude a written agreement with the bank concerning a program of remedial action; or issue written orders to cease and desist from violations and to undertake remedial action. The Commission shall apply to the Supreme Court, Trial Division, for a cease and desist order. The Commission can also impose fines on the financial institution or on its administrators or principal shareholders in an amount of up to \$10,000 per day for each day that the violation continues. Administrators may be suspended temporarily or dismissed from positions in a financial institution. The Commission may impose restrictions on the operations of the financial institution. As an extreme measure the Commission can revoke the license of the financial institution and order it to dissolve or appoint a receiver for the bank under the FIA. All the measures are applicable to persons who, inter alia, are engaged in banking business without a proper license. The Commission is also, regardless of any other provision of law, authorized to liquidate the business of such person under the receivership provisions of the FIA in case of insolvency.</p> <p>The FIC is empowered to have a member of a bank’s board member disqualified.</p> <p>A breach of the minimum capital adequacy ratio is not explicitly stated as a ground for revocation of a license.</p> <p>For Palau (domestic) banks whose capital is determined by the Commission to be less than three-quarters of the required minimum capital, in addition to the above measures, the Commission shall require the bank to adopt a capital restoration plan satisfactory to the Commission that provides for the bank to attain capital adequacy within six months from the determination by the Commission.</p>
<p>Assessment</p>	<p>LARGELY COMPLIANT</p>
<p>Comments</p>	<p>The supervisory authority has a range of measures at its disposal. A breach of the minimum capital adequacy ratio ought to be explicitly stated as grounds for revocation of a license. The FIC should be able to take remedial action on a weakening of the capital base with less than 25% of the minimum amount being lost. The FIC’s powers to form views of safety and soundness issues, and subsequently to take prompt remedial action, are constrained by the basic provision of the FIA that delineates the disclosure of wrong doings in banks the primary purpose of bank examinations. The FIC’s powers to take timely remedial action are limited by conferring the Supreme Court powers make the final on whether to issue a cease and desist</p>

	order to a bank that is in contravention of legal provisions.
Principle 23.	Globally Consolidated Supervision Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.
Description	There are no provisions on an approval procedure for the foreign operations of Palau banks. The supervisor has no powers to require closing of overseas branches. According to the FIA, consolidated supervision is only applied to foreign banks.
Assessment	NON-COMPLIANT
Comments	Notwithstanding the fact that the domestic banks have no overseas operations, the FIA is deficient in that consolidated supervision of Palau banks is not provided for and the FIC has no powers to limit the scope of foreign operations of banks.
Principle 24.	Host Country Supervision A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
Description	The FIC is empowered by virtue of section 8 the FIA to exchange information with foreign authorities. The FIC has no legal powers to prohibit banks from establishing foreign operations where secrecy laws limit the exchange of information between authorities.
Assessment	NON-COMPLIANT
Comments	The work of the FIC was in a very formative phase at the time of the mission. No definite comment may be made on this supervisory arrangement.
Principle 25.	Supervision Over Foreign Banks' Establishments Banking supervisors must require the local operations of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.
Description	The prudential regulations of section 53 are applied only on a consolidated basis to foreign banks. The FIA and the regulations issued on the basis of it are applied only insofar as the compliance of foreign branches with such requirements is consistent with and does not conflict with the national law of the foreign bank's home jurisdiction. There are specific provisions concerning foreign banks, e.g. regarding the absolute amount of capital and the obligation to employ external auditors. According to section 33(c), a license for a subsidiary or branch office of a foreign bank can only be granted if: (1) the foreign bank is authorized to engage in the business of receiving money deposits or other repayable funds in the jurisdiction or foreign country where its head office is located; (2) the competent authorities that supervise the financial activities at the head office of the foreign bank concerned have given their written consent to the granting of such license; and (3) the Commission determines that the foreign bank is adequately supervised on a consolidated basis by its supervisory authorities. The law is silent as to the rights of foreign supervisory authorities to undertake inspections at Palau branches and subsidiaries of foreign banks. No standing arrangements on cooperation with foreign supervisory authorities have been established as yet.
Assessment	LARGELY COMPLIANT
Comments	Arrangements for the exchange of information with foreign supervisors would need to be established in Memoranda of Understanding.

Table 2. Summary Compliance with the Basel Core Principles

Core Principle	C ^{1/}	LC ^{2/}	MNC ^{3/}	NC ^{4/}	NA ^{5/}
1. Objectives, Autonomy, Powers, and Resources			X		
1.1 Objectives		X			
1.2 Independence			X		
1.3 Legal framework			X		
1.4 Enforcement powers			X		
1.5 Legal protection	X				
1.6 Information sharing		X			
2. Permissible Activities	X				
3. Licensing Criteria			X		
4. Ownership		X			
5. Investment Criteria			X		
6. Capital Adequacy				X	
7. Credit Policies				X	
8. Loan Evaluation and Loan-Loss Provisioning				X	
9. Large Exposure Limits			X		
10. Connected Lending		X			
11. Country Risk				X	
12. Market Risks				X	
13. Other Risks				X	
14. Internal Control and Audit		X			
15. Money Laundering		X			
16. Onsite and Offsite Supervision				X	
17. Bank Management Contact				X	
18. Offsite Supervision			X		
19. Validation of Supervisory Information			X		
20. Consolidated Supervision				X	
21. Accounting Standards			X		
22. Remedial Measures		X			
23. Globally Consolidated Supervision				X	
24. Host Country Supervision				X	
25. Supervision Over Foreign Banks' Establishments		X			

^{1/} C: Compliant.

^{2/} LC: Largely compliant.

^{3/} MNC: Materially non-compliant.

^{4/} NC: Non-compliant.

^{5/} NA: Not applicable.

Recommended action plan and authorities' response to the assessment

Recommended action plan

Table 3. Recommended Action Plan to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
1(1) An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.	In order to remove an obstacle in the way of the FIA's provisions from becoming applicable within the near future, all the posts of the Board should be filled. To that end, the eligibility provision should be amended to make a wider array of people eligible for Board membership.
1 (2) Each such agency should possess operational independence and adequate resources.	The operational independence of the FIC ought to be enhanced by amending the legal provision that gives the power to appoint the Executive Commissioner to the Board. The power should be vested with the President of the Republic, a common practice in the country. A provision to be abolished that also materially undermines the FIC's independence is the one that gives the OEK effectively powers to pre-empt the issuance of a prudential regulation by the FIC. The legal limit on the supervisory fees that banks are charged ought to be lifted in order to provide the FIC with adequate resources.
1 (4) A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns	The FIC's powers to address safety and soundness concerns are curtailed by the provision stating the disclosure of irregularities and malfeasance in a bank as the primary purpose of bank examinations. A general risk management provision in the FIA giving the FIC powers to give a judgment on a bank's general risk situation ought to be enacted. The FIC should be able to issue cease and desist orders without seeking a court order.
2 Permissible Activities	A legal provision ought to be enacted that would limit the scope of a bank's permissible activities depending on the amount of its capital base.
3 Licensing criteria	The ambiguousness of the grandfathering provisions regarding the FIC's supervisory powers vis-à-vis the existing banks, should be removed by, e.g. circulating a FIC statement to the banking sector. To counterbalance the effect of the exemptions that the "EFI" banks have been awarded in the simplified licensing process, the FIC ought to issue regulations requiring banks to furnish practical plans as to the level of their capital and profitability. Preliminary information on compliance of the major prudential standards ought to be submitted as well. The FIC should provide more detailed licensing guidelines for banks regarding especially fit & proper tests and the operational policies, and internal control procedures of the applicant.

Reference Principle	Recommended Action
5 Investment criteria	There ought to be clear rules as to what kind of investments need supervisory approval and which are subject to notification only. A major consideration in the provisions should be an assessment whether the planned corporate affiliations would be deleterious to the effective supervision of a bank.
6 Capital adequacy	The legal capital adequacy requirement of 5% ought to be raised to conform to the internationally accepted minimum standard of 8%. Capital adequacy should be calculated on a consolidated basis. The law should be amended to provide for a more detailed definition of regulatory capital and the risk weighting of different kinds of assets. A breach of the minimum capital adequacy ratio ought to be explicitly stated as grounds for revocation of a license. The FIC should be able to take remedial action on a weakening of the capital base with less than 25% of the minimum amount being lost.
8 Loan Evaluation and Loan-Loss Provisioning	Regulations ought to be issued concerning asset classification, loan loss provisioning, and reporting of substandard loans. The FIC should be empowered to require a bank to, inter alia, strengthen its lending practices and level of provisions.
9 Large exposure limits	There should be legal provisions or regulations on the way different types of credit and contingent liabilities are to be included in the calculation of a large exposure. The large exposure regulations ought to be applied on a consolidated basis
11 Country risk 12 Market risks 13 Other risks	The FIC should have in place a set of guidelines for the policies and procedures for the management of the different varieties of risk when applicable.
16 On-site and off-site supervision	There should be developed for the FIC an operational mode that combines in a way appropriate to the particular conditions of the markets both on-site examinations and a framework of prudential reporting.
17 Bank management contact	The supervisor should require banks to inform it of any substantive changes in their activities or adverse developments that might breach legal or prudential requirements.
18 Off-site supervision	The FIC ought to be given explicit powers to require any information it needs for supervisory purposes. The FIC has also to build an analytical base for monitoring banks and for using as a component of planning examinations.

Reference Principle	Recommended Action
21 Accounting standards	The law should require all banks to disclose their financial statements. All banks should equally have to have their financial statements audited by external auditors. The supervisor ought to be given powers to revoke the appointment of an auditor. Auditors should have a legal obligation to report to the FIC of material events in a bank's activity or violations of banking law.
23 Globally consolidated supervision 24 Host country supervision 25 Supervision over foreign banks' establishments	The law should have provisions on the FIC's powers to have controls on the foreign operations of Palau banks. The establishment of branches or subsidiaries should be subject to the FIC's approval. The FIC should have explicit powers to close down foreign operations. To secure the exchange of information between authorities there should be memoranda of understanding between the FIC and foreign supervisory authorities.

Authorities' response to the assessment

17. The authorities' response to the assessment is as follows:

“The Financial Institutions Commission is in receipt of the draft IMF Module II Assessment Report forwarded to us by the Ministry of Finance. The FIC Governing Board has reviewed the Executive Summary contained in the report, and find the recommendations in line with the final review and evaluation meeting between the FIC and the Module II Assessment team.

In general, the FIC agrees that the changes recommended in the report should be implemented. We will be working closely with Mr. John Vaught, our Technical Consultant from the IMF, to formulate regulations and supervisory policies that will bring the Republic of Palau into compliance with the Basel Core Principles, keeping in mind the recommendations of the Module II assessment.

We look forward to working with the Ministry of Finance and all relevant agencies in building sound standards for the regulation and supervision of financial institutions within the Republic of Palau.”

II. ASSESSMENT OF THE LEGAL, INSTITUTIONAL AND SUPERVISORY ASPECTS FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM (AML/CFT)

A. Summary

Summary Assessment

18. The mission assessed Palau's measures in anti-money laundering and combating the financing of terrorism ("AML/CFT") using the IMF and World Bank *Methodology for Assessing Legal, Institutional, and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism* (the "AML/CFT Methodology").¹

19. The mission's overall assessment is that Palau has a largely satisfactory legal and institutional framework for preventing and detecting money laundering in the banking sector. That said, the mission also finds that implementation capabilities need strengthening. This is due to a number of factors: (i) while providing for the establishment of a Financial Intelligence Unit (FIU), the AML legislation does not provide it with clear powers to conduct on-site inspections, to undertake enforcement, and to ensure compliance by reporting entities; (ii) the FIU is currently understaffed and lacks sufficient expertise to carry out the tasks assigned to it by the legislation, namely in the analysis of suspicious transactions; and (iii) banks need to be provided with clear guidelines and recommendations from the FIU on how to deal with the practical aspects of day-to-day implementation of the AML legislation, particularly the identification of suspicious transactions.

20. Partly in response to the envisaged review of its anti-money laundering measures by the Financial Action Task Force (FATF) in September 2001, in June Palau established a comprehensive anti-money laundering framework. There was a package of anti-money laundering laws enacted in June 2001, i.e., the Money Laundering and Proceeds of Crime Act 2001 (AML Law) and the Mutual Assistance in Criminal Matters Act 2001 that largely form the basis of Palau's anti-money laundering framework. The laws were initially drafted by a consultant from the Pacific Islands Forum Secretariat and reviewed by Palau's authorities. In addition, the Financial Institutions Act 2001, the Foreign Evidence Act 2001 and the Extradition Act 2001 have significantly augmented Palau's anti-money laundering framework. The creation of Palau's Financial Intelligence Unit (FIU) in November 2001 could add an important dimension to Palau's capabilities for combating money laundering and the financing of terrorism if it had sufficient powers and implementation capabilities.

¹ For the review of anti-money laundering, the mission observed the guidance in the draft AML/CFT methodology document that was issued to the IMF's Executive Board on February 7, 2002.

21. The Palau Government has demonstrated a clear political commitment to ensure that strong AML/CFT measures are in place for the entire financial system. In addition to being a signatory to the Honiara Declaration, the Palau Government has more recently volunteered to participate in an initiative led by the Forum Secretariat and the Asia/Pacific Group on Money laundering to assist member countries of the Pacific Forum to put in place effective measures for anti-money laundering, combating financing of terrorism, and financial sector fraud that is being funded by the IMF's Legal Department (LEG). In this connection, the Palau Government has agreed that LEG undertake an assessment of its FIU's operations. Additionally, the Palau's Government intends to join the Asia/Pacific Group on Money Laundering. In response to the calls by various international bodies to have in place measures to combat the financing of terrorism, Palau is in the process of drafting anti-terrorism legislation and has set up a Task Force on Anti-Terrorism and Homeland Security.

22. The mission reviewed the provisions of the Financial Institutions Act 2001 (FIA) and is of the view that the FIA is adequate with respect to the legal and institutional framework for the supervision and integrity standards for banks.

23. The assessment, however, underscored a gap in the supervisory regime governing AML as the supervisory authority who will implement AML requirements on a day-to-day basis is not clearly identified. The initial thinking in the Palau Government was that the Financial Institutions Commission (FIC) should have the responsibility. However, should that be the case, the mission notes that there would be a residual group of reporting entities, such as exchange offices and money transmitters, that are not regulated and supervised by the FIC and, therefore, the question of who would be the relevant supervisory authority for those entities would still remain.

24. In order to make the distinction in responsibilities more clear, and to provide a single entity, the FIU, with clear AML inspection, compliance and enforcement powers, the mission strongly recommends that the FIC should be responsible for establishing AML policies and procedures for banks, while the FIU should be given responsibility for the day-to-day implementation (including on-site inspection) and enforcement of AML requirements for all reporting entities, including banks. Additionally, the mission recommends a number of technical amendments to the legal framework (as stated below) to ensure effective implementation of AML legislation. These, can be summarized as follows:

- Begin implementation of the existing AML provisions immediately;
- The *FIC* should be responsible for establishing adequate *policies and procedures for AML for banks*, while the *FIU* should be given responsibility for the *day-to-day implementation and enforcement of AML requirements for all supervised entities, including banks*;
- Amend the AML law to include the following: (i) specific record keeping requirements; (ii) lower the threshold when identifying casual clients; (iii) removal of the threshold of \$10,000 for the record keeping requirement for customer identification; (iv) prohibition of anonymous accounts; (v) clarifying the suspicious

- transaction reporting requirements; (vi) extending the scope of the provisions overriding secrecy and the tipping off provisions; (vii) redefining the definition of money laundering so that the *mens rea* element is clearly set out; (viii) setting out the predicate offenses to which the money laundering offence relate, based on the concept that all crimes would be considered predicate offenses, as envisioned by the authorities and to include in the scope of predicate offenses similar offenses committed extraterritorially; (ix) extend the power to confiscate the proceeds of money laundering offenses and predicate offenses, instrumentalities and subject matter of money laundering offenses and, in the event that the proceeds of crime or instrumentalities or subject matter of the offense are not available for confiscation, the court should have the power to order confiscation of property of an equivalent value or a penalty sum equivalent to the value of property; (x) include adequate procedures for the protection of innocent and bona fide third party interest; and (xi) require customer identification for wire transfers;
- Amend the AML law to vest the FIU with the following powers: (i) to disseminate information that it receives, either on request or on its own initiative, to the relevant law enforcement agencies, foreign and local, where it suspects a money laundering offense, with adequate safeguards including confidentiality as to the use of the information so disseminated; (ii) to audit compliance and conduct on-site inspection of the financial intermediaries with the AML law, as well as to have enforcement authority with respect to reporting entities; (iii) to facilitate advisory activity, research and training and education of the public; (iv) to protect the FIU and the information that the FIU receives from suit and compulsory legal process; and (v) to have access to public information;
 - Provide the FIU with adequate staffing and expertise;
 - Provide the FIU with powers to issue regulations for the effective implementation of the AML Law;
 - Establish a training program for the FIU, financial intermediaries, and the Attorney General's office in the relevant areas pertaining to money laundering. Technical assistance from MAE and LEG is being envisaged already for this purpose. It may be augmented if warranted;
 - Specifically with respect to the banking sector, consideration should be given to requiring the application of the "fit-and-proper" tests to controlling shareholders and management of the 12 institutions which have applied for a banking license under the "grandfathering" provisions of the FIA;
 - Enact the anti-terrorism legislation as soon as possible and issue regulations for the registration of over-the-counter exchange dealers.

B. Detailed Assessment

Information and methodology used for the assessment

25. Palau's anti-money laundering system was assessed for compliance with the criteria described in Part 1 of the AML/CFT methodology for assessment of the legal and institutional framework and Part 2, module one, financial supervisory principles in the prevention of money laundering and combating the financing of terrorism with respect to banks. The assessment is based on a review of the legislation, and interviews with staff of the Ministry of Finance (MOF), FIU, the Attorney General, Ministry of Justice, five of Palau's twelve banks, and the FIC. Of the 12 broad criteria assessed, the mission found Palau to be compliant with 2 criteria; largely compliant with 5 criteria; materially non-compliant with 3 criteria; and non-compliant with 2 criteria.

26. The FIU was very helpful in organizing meetings with the other government officials and private bodies. The mission appreciated the quick responses to the assessors' requests for additional information and statistics needed to complete this assessment. Prior to and during the mission, the FIU provided the assessors with numerous resource documents, including the laws and regulations and relevant reports.

27. The mission reviewed a previous assessment conducted by the FATF which had detailed several weaknesses in Palau's anti-money laundering framework.

Legislative and Regulatory Framework

28. Palau's legal framework in anti-money laundering is largely contained in the AML law and in the Mutual Assistance in Criminal Matters Act 2001. The AML law provides for the criminalizing of money laundering; the creation of an FIU with the powers to receive suspicious transactions reports and analyze them, comprehensive customer identification requirements; some record keeping requirements; suspicious transaction reporting requirements; provisions overriding secrecy for purposes of reporting under the AML law, protection for those reporting from suit; prohibition against tipping off; confiscation of the subject of money laundering offenses and the benefits derived therefrom and provisional measures such as seizing and freezing powers during money laundering investigations. The Mutual Assistance in Criminal Matters Act 2001 provides for assistance to be provided to and by Palau in investigations and prosecutions including the powers for production of documents, seizure of documents and property and freezing, seizing and confiscation of proceeds of money laundering offenses. The admissibility of some types of foreign evidence is provided for in the Foreign Evidence Act while extradition for money laundering offenses is provided in the Extradition Act.

29. A number of supervisory aspects as required by international best practices for AML are provided for in the FIA but as regulations under the FIA and the AML law have yet to be issued it is to be considered a work in progress. Palau officials, including the FIC, FIU, MOF and the AG have already shown a commitment to ensuring that the full scope of the AML Law is operational.

30. The money laundering offense is very wide and covers the conversion or transfer of property for the purpose of concealing or disguising the illegal origin of such property; or the concealment or disguise of the illegal nature, source, location, disposition, movement, or ownership of property; or the acquisition, possession, or control of property by any person who knows that the property constitutes the proceeds of crime as defined herein. The law provides that knowledge, intent, or purpose is required as an element of the offense of money laundering and may be inferred from objective factual circumstances. But it is unclear what this knowledge should relate to.

31. The FIU Coordinator was appointed on November 19, 2001 and has issued two advisories to financial intermediaries. The first sets out the obligations of financial intermediaries under the AML Law and includes the form to be used in submitting suspicious transaction reports. In its second advisory, the FIU issued a directive to all banks requesting they investigate the names provided on the U.S. and U.N. list of entities and individuals connected with terrorism. No assets connected with the names provided were located in Palau.

32. Palau banks have some AML procedures and controls in place, especially the FDIC-regulated banks that are required to comply with U.S. anti-money laundering laws. They require guidance as to the details of the procedures and internal controls and measures that they have to put in place to fully comply with the AML law. The banks also require training for their staff on the AML Law and anti-money laundering measures like the recognition of suspicious transactions. Regulations need to be issued to help financial intermediaries comply with the various requirements.

33. The Palau Government views the combating of terrorism seriously and has set up a Task Force on Anti-Terrorism and Homeland Security. There is also anti-terrorism legislation being drafted. One of the CFT measures already in place is the requirement to register over the counter exchange dealers in the AML Law. However regulations have yet to be issued for their registration and regulatory framework. The FIU has indicated that it requires technical assistance with the drafting of these regulations

Organizational Framework

34. The AML law imposes anti-money laundering compliance on a broad range of financial intermediaries as follows: banks, savings and loan institutions, credit unions, securities brokers or dealers, or an entity or person whose primary business activity includes acceptance of deposits and other repayable funds from the public; lending, including consumer credit, mortgage credit, factoring (with or without recourse) and financing of commercial transactions; financial leasing; money transmission services; issuing and administering means of payment (such as credit cards, travelers checks and bankers draft); guarantees and commitments; trading for account of customers in money market instruments (such as checks, bills, certificates of deposit), foreign exchange, financial futures and options, exchange and interest rate instruments and transferable securities; underwriting share issues and participation in such issues; money brokering; portfolio management and

advice; safekeeping and administration of securities; credit reference services; safe custody services. Some of these types of intermediaries do not currently exist in Palau.

35. The AML law vests specific government officials with a role in Palau's anti-money laundering effort. The FIU is responsible for receiving suspicious transaction reports, analyzing them, freezing funds suspected of being involved in money laundering, providing assistance to counterpart FIUs and assisting in money laundering investigations. The AML law is silent on who exercises supervisory powers over anti-money laundering measures or who is vested with the power to ensure that these financial intermediaries comply with the AML requirements. The Police Department's Criminal Investigation Division would be investigating money laundering offenses while the Supreme Court is vested the power to grant the various orders under the AML law. The Attorney General and the Ministry of State are responsible for responding to, and requesting international requests for assistance under the Mutual Assistance in Criminal Matters Act 2001. The MOF does not maintain a direct role in AML supervision but would together with the Ministry of Justice be responsible for any changes in the anti-money laundering legal framework.

36. Section 48 of the FIA prohibits any financial institutions from concealing, converting, or transferring cash or other property, knowing that such property is derived from criminal activity, for the purpose of concealing or disguising the illegal origin of the property or from knowingly assisting any person who is involved in such activity from evading the legal consequences of his or her action. The knowledge described may be inferred from objective factual circumstances. The FIC has the power to ensure the financial institutions' compliance with these provisions and with the provisions of any other law. However, financial institutions form only a portion of the financial intermediaries covered within the ambit of the AML law.

37. The AML law imposes customer identification and verification, record keeping and suspicious transaction reporting on all financial intermediaries set out in paragraph 16 above. The FIU has stated its intention to issue regulations and guidelines to the industry but would require assistance to do so as it does not have the expertise and lacks resources. Banks are by far the most significant financial intermediaries in Palau. Notwithstanding who is ultimately vested with the supervisory powers over anti-money laundering matters, the FIU envisages working with the FIC and the AG in drafting these regulations and guidelines. However, several of these banks are FDIC regulated banks and are already subject to prudential supervision, as well anti-money laundering requirements by their home country supervisors. As such they would be a source of information that could be utilized by the FIU and local bankers.

38. There is a requirement in the AML law that requires that over the counter exchange dealers be registered by the FIU. The FIU would be the supervisor of these entities under the AML law. However, the regulatory framework for these institutions has not been established.

As the banks are empowered under the FIA, too under this activity, the FIU should consult with the FIC in establishing the regulatory framework for these entities.²

39. The Mission notes that the implementation of the anti-money laundering requirements for banks is in its infancy and appears to be non-existent for other intermediaries. The institutional framework in terms of the FIU is not yet fully operational as Palau lacks resources and expertise. Thus far, only a Coordinator has been appointed. The supervisory aspect of the anti-money laundering framework needs to be clearly provided for in law with the Palau government clearly defining whom that supervisor would be. A full picture of the implementation at the bank level will be understood at a later stage. Full effective implementation of the anti-money laundering measures would require the issuance of regulations and the provision of training. Ensuring full implementation may require additional resources for the FIU.

Part 1: Assessing the AML/CFT in the legal and institutional framework

Table 4. Detailed assessment of the legal and institutional arrangements for AML/CFT

Legal requirements for supervision and regulation	
<i>Client Due Diligence</i>	
Financial intermediaries ³ should be required to verify the identity of customers, to keep records of financial transactions, and to report unusual or suspicious transactions to the FIU.	
Description	<p>Verification</p> <p>Section 7 of the AML law requires financial intermediaries to verify their customer’s identity and address before opening ordinary accounts or passbooks, taking stocks, bonds or other securities into safekeeping, granting safe-deposit facilities, managing assets, or effecting or receiving payments on behalf of either natural or legal persons.</p> <p>Any person who opens an account in a false name is guilty of an offence.</p> <p>Section 7 also sets out the identification documents required for natural and legal persons.</p> <p>Verification of customers is limited to those transactions set out in section 7.</p> <p>Section 8 requires financial intermediaries to identify all casual customers if the sum of</p>

² Regulating foreign exchange dealer and money remitters is also required by the Special Recommendations to Combat Financing of Terrorism and is included in the AML/CFT Methodology document.

³ Financial intermediary means a bank, savings and loan institution, credit union, securities broker or dealer, or an entity or person whose primary business activity include acceptance of deposits and other repayable funds from the public; lending, including consumer credit, mortgage credit, factoring (with or without recourse) and financing of commercial transactions; financial leasing; money transmission services; issuing and administering means of payment (such as credit cards, travelers checks and bankers draft); guarantees and commitments; trading for account of customers in money market instruments (such as checks, bills certificates of deposit), foreign exchange, financial futures and options, exchange and interest rate instruments, and transferable securities; underwriting share issues and participation in such issues; money brokering; portfolio management and advice; safekeeping and administration of securities; credit reference services; safe custody services.

the transaction is over \$10,000. If the amount of the transaction is unknown at the time of operation, the customer shall be identified as soon as the threshold amount of \$10,000 becomes known or is reached by the customer. In addition, casual customers would also be identified if their transactions were conducted in a manner that reasonably appears to have an unlawful criminal purpose. It is not stated what kind of identification documents are required. Casual customers are also not defined.

Section 9 of the AML law also requires financial intermediaries to identify the beneficial owner where it is uncertain whether the customer is acting on his or her own behalf. The financial intermediary shall seek information by any legal or reasonable means to ascertain the true identity of the principal or party on whose behalf the customer is acting.

Section 14 of the AML law requires over the counter exchange dealers to verify the identity of their customers where the transaction is greater than \$2,500 or in any case where the transaction is conducted in conditions of unusual or unjustified complexity. For these transactions the verification documentation is specified, i.e., an official original document of identification of the customer that is unexpired and bears a photograph, a copy of which shall be taken.

Record keeping

Section 5 of the AML law requires financial intermediaries to keep regular reports of all transactions made in cash or bearer securities in excess of \$10,000 or its equivalent in foreign cash or bearer securities.

Section 11 of the AML law requires financial intermediaries to maintain and hold at the disposal of the authorities, pursuant to an order of the Supreme Court, records of customer identification for five years after the account has been closed or the relations with the customer have ended and records of transactions where the transaction involves a sum greater than \$10,000 and is conducted in a manner that appears to have an unlawful purpose. Records of all other transactions are not kept. However, the Unified Tax Act requires records of transactions to be kept for three years for tax purposes, but this period is less than the minimum international standard of five years.

Pursuant to section 12 of the AML law the customer verification records can only be delivered to the FIU and the Office of the Attorney General upon the application of the Office of the Attorney General to the Supreme Court, Trial Division, for an order allowing the FIU and the Office of the Attorney General to examine the contents of these reports and records of a financial intermediary based upon a finding of probable cause.

Suspicious transaction reporting

There are two suspicious transaction reporting provisions, one in section 10 that provides that where the transaction involves a sum greater than \$10,000 and is conducted in a manner that appears to have an unlawful purpose, financial intermediaries shall provide information as to the origin and destination of the money, the purpose of the transaction, the identity of the transacting parties, methods of the transaction and the identity of the principal to the FIU and the Office of the Attorney General. However, section 12 of the AML law imposes a further requirement that these records can only be made available upon obtaining an order from the Supreme Court when an investigation is under way.

The other provision is in section 19 of the AML law and that provision requires any natural or legal person who in connection with his trade or occupation, carries out or advises on operations involving deposits, exchange operations, investments, conversions, or any other movements of capital, to report to the FIU transactions in section 10 involving money that reasonably appears to be derived from money laundering. The reporting requirement is imposed even where it is not feasible to defer the execution of the transaction or it becomes clear after the transaction is completed that it involves money laundering. This section is narrower than section 10 as it only relates to transactions that reasonably appear to be derived from money laundering as opposed to a transaction that is conducted in a manner that appears to have an unlawful

	<p>purpose There is no requirement to obtain a court order before such a report can be made to the FIU.</p> <p>There is no specific requirement in the AML law that if a financial intermediary has reason to suspect that funds involved in a transaction are used to finance terrorism it has to report it as a suspicious transaction. However, the FIU has issued an advisory requiring financial intermediaries to report as suspicious transactions any transactions or funds related to the list of persons and organizations published by the U.S. and the U.N.</p> <p>Overriding banking secrecy</p> <p>Section 25 of the AML law provides that banking or professional secrecy may not be invoked as grounds for refusal to provide information relating to suspicious transaction under section 10 and record keeping documents or documents required in connection with an investigation which relates to money laundering and is ordered by or carried out pursuant to an order of the Supreme Court. It is not clearly stated that banking secrecy is overridden for purposes of reporting under section 19 of the AML law.</p> <p>Protection for reporting institutions</p> <p>Section 21(b) of the AML law specifically provides that no civil or criminal action may be brought, nor any professional sanction taken, against a financial intermediary who in good faith transmits information or submits reports pursuant to the AML law, even if the investigation or judicial decision does not give rise to a charge for any offense. This provision gives financial intermediaries protection when making suspicious transaction reports to the FIU.</p> <p>Tipping off</p> <p>Section 12 (d) of the AML law prohibits tipping off. It provides that upon receipt of confidential information by the Office of the Attorney General pursuant to this section, the Ministry of Justice, FIU, the Office of the Attorney General, and all related employees and agencies shall be prohibited from disclosing or making known the existence and content of the information received. Under no circumstances shall such persons be required to transmit the above information and reports, nor shall any other individual having knowledge of the information or report be required to communicate such information or reports to any natural or legal person other than to the FIU and the Office of the Attorney General.</p> <p>Section 31 of the AML law also provides that a penalty of not more than two years imprisonment or a fine not to exceed \$10,000 will be imposed on persons and directors or employees of organizations that carry out or advise on operations involving deposits, exchange operations, investments, conversions, or any other movements of capital, and in particular to financial intermediaries, who knowingly disclose, to the owner of the sums or to the principal of the transactions, a report which they are required to make or the action taken as specified in sections 10, 12, 19, and 24 of the AML law. The same penalty is imposed on a person for not making a suspicious transaction report as required by the AML Law.</p> <p>Internal Policies and Procedures</p> <p>Section 13 of the AML law requires financial intermediaries; including money remitters and exchange dealers to develop written policies and procedures to the extent such programs and procedures do not currently exist, for the prevention of money laundering. Policies and procedures to deter financing of terrorism are not specifically referred to. Such programs should include the centralization of information on the identity of customers, principals, beneficiaries, authorized agents, beneficial owners, and suspicious transactions; the designation of compliance officers at central management level, in each branch and at each agency or local office; on-going training for officials or employees; internal audit arrangements to check compliance with, and effectiveness of, the measures taken to implement the AML law.</p> <p>Fit and proper person</p> <p>Section 44 of the FIA provides that all persons elected or appointed as administrators of a</p>
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	<p>financial institution must be of good repute and must meet the criteria established by regulation of the FIC regarding qualifications, experience, and integrity. No regulations have been made yet. Administrator is defined to mean any person who is an officer of a financial institution or other juridical person, including any member of the board of directors or the Audit Committee, or the head of a department of the organization but shall only apply to a person who is regularly employed at the Palau office of the financial institution.</p> <p>Sanctions</p> <p>Adequate sanctions are provided for failure to comply with any of the above requirements. Section 30 of the AML law provides that any person who fails to comply with the above provisions shall, upon conviction therefor on the basis of clear and convincing evidence, be subject to a civil penalty not to exceed \$50,000 upon application by the Office of the Attorney General.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>The requirement to identify casual clients should have a lower threshold limitation. There should be a prohibition of anonymous accounts.</p> <p>There should be record keeping requirements for any transaction conducted by financial intermediaries for at least five years after the termination of the account or business relationship and these records should be available for the inspection of the FIU without the need for an order of the Supreme Court. The records kept should be sufficient to permit the reconstruction of individual transactions so as to provide evidence for prosecution of criminal behavior. The records should at a minimum include the customers name, address or other identifying information normally recorded by the intermediary, nature and date of the transaction, type and amount of currency involved and details of the account. The threshold of \$10,000 for the record keeping requirement for customer identification documents should be removed.</p> <p>There is no specific requirement that financial intermediaries give special attention to transactions with persons in jurisdictions that do not have adequate systems in place to prevent or deter money laundering or the financing of terrorism.</p> <p>Financial intermediaries should be required to identify all complex or unusual transactions and complex or unusual patterns of transactions, transactions that have no apparent or visible economic or lawful purpose and to examine the background of such transactions and to send such information to the FIU as suspicious transactions. Financial intermediaries should be required to include originator information and related messages on funds transfers that should remain through the payment chain. There should also be customer verification for wire transfers.</p> <p>The FIU is of the view that the reporting requirement in section 10 does not require an order of the Supreme Court and in practice this has been done. The Mission is of the view that suspicious transactions relating to money laundering pursuant to section 10 of the AML law can be reported to the FIU without the order of the court. If a suspicious transactions report is made because the transaction is conducted in a manner that it appears to have an unlawful purpose then the FIU can only obtain that report from the financial intermediary upon obtaining an order of the Supreme Court. The FIU should be sent the suspicious transactions reports without having to go to the Supreme Court. The FIU should have access to reports of all transactions made in cash or bearer securities in excess of \$10,000 or its equivalent in foreign cash or bearer security that are kept by financial intermediaries pursuant to section 5 of the AML law. The suspicious transactions reporting requirement should be clarified.</p> <p>The overriding of secrecy should be specifically extended to all reporting requirements especially the reporting requirement under section 19 of the AML law.</p> <p>There is no specific provision requiring financial intermediaries to screen applicants for employment to prevent the use of their institutions by money launderers or terrorists or to provide employees with training in the recognition and handling of terrorism financing.</p> <p>The tipping off provision in section 12(d) should be amended to make it clear that it covers disclosures made under section 19 of the AML law to prevent ambiguity and should also cover any person who has knowledge of a suspicious transaction report.</p>

	<p>The sanctions in section 30 for non-compliance should be made specifically to apply to non-compliance with section 19 of the AML law to prevent ambiguity.</p>
<p>Legal requirements for supervision and regulation <i>Fit and Proper Test and Financial Transparency</i></p> <p>Laws should provide that criminals do not control financial institutions and other financial intermediaries. Laws should also provide that companies or other entities subject to any specific benefit from or regulation by the state are not controlled by serious criminals.</p>	
<p>Description</p>	<p>Licensing and registration requirements</p> <p>Section 3 of the FIA provides for the licensing of a bank, securities broker, or securities dealer by the FIC.</p> <p>Section 14 of the AML law requires over the counter exchange dealers to obtain a license from the Minister of Justice.</p> <p>Fit and proper test for controlling shareholders and management</p> <p>Section 30 of the FIA provides that the FIC shall only grant a license to a financial institution if, among others, the qualifications, experience, and integrity of its administrators and significant shareholders are appropriate for its business plan and for the financial activities that the financial institution will be licensed to engage in.</p> <p>Section 40 of the FIA provides that to have legal effect, the transfer of an equity interest in a Palau financial institution shall require the prior written authorization of the Commission if, as a result of such transfer, any one person or number of persons acting in concert would, directly or indirectly, hold a significant interest in such financial institution. These decisions shall be based upon whether, in the determination of the Commission, the qualifications, experience, and integrity of the proposed shareholders are appropriate for their significant ownership of the financial institution.</p> <p>Section 44 of the FIA provides that all persons elected or appointed as administrators of a financial institution must be of good repute and must meet the criteria established by regulation of the FIC regarding qualifications, experience, and integrity. No regulations have been made yet. Administrator is defined to mean any person who is an officer of a financial institution or other juridical person, including any member of the board of directors or the Audit Committee, or the head of a department of the organization but shall only apply to a person who is regularly employed at the Palau office of the financial institution.</p> <p>Section 45 of the FIA provides that a person shall not be eligible to become a member of the board of directors of a Palau financial institution, or shall by decision of the general or special meeting of shareholders of the financial institution be relieved of his or her membership on the board of directors if he or she has been convicted of a felony or a crime of moral turpitude.</p> <p>The Registrar of Corporations under the Corporations Act and the Foreign Investment Bureau under the Foreign Investments Act require all corporations to be registered under them. The corporations are required to submit among others, details of the directors, officers, management and shareholding. There are also no specific provisions requiring that there are measures to prevent these entities from being used as conduits for criminal proceeds or terrorist financing and from concealing or obscuring the diversion of funds intended for legitimate purposes to terrorist organizations.</p> <p>These corporations are required by Regulations (5.4, 5.5) to file with the Registrar exhibits of its state of affairs annually, including their accounts. Failure to do so will make them liable after due process to have their certificates revoked. In addition these corporations have to obtain a license from the tax authorities if they want to do business. However there are no specific requirements prohibiting criminals from owning, or controlling these corporations or prohibiting criminals from abusing these corporations. The Registrar of Corporations and the Foreign Investment Bureau have the power to enforce compliance with these requirements.</p>

Assessment	LARGELY COMPLIANT
Comments	<p>As the existing banks are deemed to be registered under the FIA upon submission of among other things a certificate of good standing from the relevant authorities, the FIC as the supervisory authority would have to depend on the requirements of the Registrar of Corporations and the Foreign Investment Bureau to ensure that these institutions do not have serious criminals holding significant investments or holding any management functions.</p> <p>In registering corporations, the Registrar of Companies and the Foreign Investment Bureau should require that those owning, controlling or managing these institutions should get a police clearance and in particular should not be serious criminals. While the Foreign Investment Bureau for some cases is doing this, the Registrar of Corporations and the Foreign Investment Bureau should consider including that as a requirement in all cases.</p> <p>As money remittance/ transmission entities seem to play a significant role, Palau should consider licensing then under the AML law.</p>
<p>Criminalization of money laundering and terrorism finance</p> <p>Laws should provide for the criminalization of money laundering and terrorism financing. Money laundering and financing of terrorism should be separate offences. Money laundering should extend to all serious crimes and should be defined in accordance with the definitions set out in the Vienna and Palermo Conventions. Financing of terrorism should conform to the definition set out in the UN Convention on Financing of Terrorism.⁴ The criteria below are consistent with FATF Recommendations 1, 4, and 5 and FATF Special Recommendation II.</p>	
Description	<p>Signing of Conventions Palau has signed the Vienna Convention. The Palermo Convention has not been signed.</p> <p>Criminalizing money laundering Money laundering is criminalized as a separate offense in section 3 of the AML law. Money laundering is defined as the conversion or transfer of property for the purpose of concealing or disguising the illegal origin of such property; or the concealment or disguise of the illegal nature, source, location, disposition, movement, or ownership of property; or the acquisition, possession, or control of property by any person who knows that the property constitutes the proceeds of crime. Knowledge, intent, or purpose is required as an element of the offense of money laundering and may be inferred from objective factual circumstances.</p> <p>It is not clearly set out what the predicate offenses are but the authorities are of the view that it extends to all offenses in the Penal Code. Except for the third limb of the definition, the <i>mens rea</i> element is not clearly set out.</p> <p>As money laundering is a separate offense a person can be guilty of both the money laundering offense and the predicate offense. There is also no necessity for a conviction of the predicate offense to establish a money laundering offense.</p> <p>The offense of money laundering relates to all property and property is defined in the AML law to mean assets of every kind, whether movable or immovable, tangible or intangible, and legal documents or instruments evidencing an interest in such assets. Monetary instruments and securities would be included.</p> <p>It is not specifically stated that offense of money laundering extends to predicate offense committed extraterritorially though the authorities are of the view it would.</p> <p>Criminalizing the financing of terrorism The financing of terrorism has not been specifically criminalized.</p>

⁴The key elements are outlined in FATF 40 4-7; UNML Articles 1 - 10, 17, 19-23, 28 - 48, 53 – 55; 56-79, UNMC Articles 21 through 33.

	<p>Sanctions</p> <p>Section 28 of the AML law provides for the penalty for the offense of money laundering for a natural person while section 29 provides for the penalty for a legal entity. Section 28 provides that any natural person convicted of violating section 3 as a principal shall be fined not less than \$5,000, nor more than double the amount laundered or attempted to be laundered, whichever is greater, or imprisoned for not more than ten years, or both. There are penalties for those who attempt, those who are accessories, those who aid and abet and those guilty of conspiracy to commit money laundering.</p> <p>Section 29 provides that corporate entities, other than the Republic of Palau, on whose behalf or for whose benefit a money laundering offense has been committed by one of their agents or representatives shall be fined in an amount equal to two times the fines specified for natural persons, with prejudice to the conviction of those individuals as perpetrators of the offense or accessories to it. In the case of corporate entities which are convicted of three or more offenses under section 3 within a five-year period, such entities may be: permanently or for a maximum of five years banned from directly or indirectly carrying on the business activities in the Republic of Palau for which they are licensed or conducted at the time of the offense; ordered to close permanently or for a maximum of five years their premises which were used for the commission of the offense; or required to publicize the judgment in the press or by radio or television.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>Palau's criminalization of money laundering provisions provides adequate coverage and criminal sanctions for money laundering.</p> <p>However the predicate offenses should be set out clearly. The predicate offense should also extend to those committed extraterritorially. The <i>mens rea</i> element for the limbs should also be clearly set out the predicate offense should also include the financing of terrorism.</p> <p>The Palau government should ratify the Palermo Convention.</p> <p>Financing of terrorism should be criminalized and the mens rea should be at least knowing financing of terrorism, and including a "should have known" element.</p>
<p>Confiscation of proceeds of crime or assets used to finance terrorism</p> <p>AML/CFT laws should provide for the confiscation of the proceeds of crime and of assets used to for FT as well as instrumentalities used to commit predicate crimes to L, for ML itself or for terrorism, <i>but should adequately protect the rights of innocent parties</i> (see FATF 7, 35, 38, III).</p>	
Description	<p>Confiscation</p> <p>The AML law provides for the confiscation of proceeds of crime and assets used by criminal organizations in the AML law. The confiscation provisions allow the confiscation of the property forming the subject of the offense and the income or other benefits obtained from the offense. However before confiscation is allowed, there has to be a conviction of the money laundering offense or an attempt to commit money laundering. The provisions further allow confiscation of any enrichment obtained during a three-year period prior to the conviction of the money laundering offense.</p> <p>Confiscation provisions do not specifically provide for the confiscation of the proceeds of assets used for the financing of terrorism.</p> <p>Section 32 of the AML law provides that in the event of a conviction for actual or attempted money laundering, an order shall be issued by the Supreme Court for the confiscation of the property forming the subject of the offense, including income and other benefits obtained therefrom, against any person to whom they may belong, if it can be established that the owner was not a bona fide purchaser for value or did not acquire the property in return for the provision of services corresponding to its value or the owner did not acquire the property on any other legitimate grounds. If the government can establish beyond a reasonable doubt the connection between such evidence and the offense, an order may additionally be issued for the confiscation of the property of the convicted offender in respect of the enrichment obtained by him or her during a period of three years preceding his or her conviction.</p>

	<p>Section 33 of the AML law further provides for the confiscation of property of criminal organizations.</p> <p>There is no power to confiscate property of an equivalent value or to order a penalty sum equivalent to the value of the property to be confiscated should the proceeds of crime be unavailable for confiscation.</p> <p>Except for the provision that confiscation will only be allowed if it can be established that the owner is not a bona fide purchaser value, there are no other provisions protecting the rights of third parties.</p> <p>There is also a provision in the drug law that allows confiscation of property if it is an instrumentality of the offense or if the property is acquired from the proceeds of drug trafficking.</p> <p>Provisional measures</p> <p>The AML law allows the seizing of property in the course of investigations; and the freezing of property by order of the Supreme Court upon a showing of probable cause. It also allows undercover operations and controlled delivery as well surveillance including tapping of phones etc.</p> <p>Section 23 of the AML law provides that in the course of an investigation, the FIU or the Office of the Attorney General may monitor bank accounts; access computer systems, networks, and servers; place under surveillance or tap telephone lines, facsimile machines, or electronic transmission or communication facilities; electronically record acts and behavior or conversations; and inspect communications of notarial and private deeds or of bank, financial, and commercial records. The Supreme Court may also order the seizure of the aforementioned documents. These operations shall be possible only when evidence exists which constitutes probable cause for suspecting that such accounts, telephone lines, computer systems and networks, or documents are or may be used by persons suspected of participating in money laundering offenses. Absent exigent circumstances, these operations shall be permitted only pursuant to a warrant issued by the Supreme Court.</p> <p>There are no specific provisions providing for the seizing or freezing of assets used for the financing of terrorism.</p> <p>Section 27 provides that the Supreme Court may upon application of the Office of the Attorney General issue a temporary order, at the expense of the national government, freezing capital and financial transactions relating to property of whatsoever nature that is liable to seizure or confiscation under this Act. Unless there is a conviction this order would last only three months.</p> <p>In addition, section 20 provides that if the FIU considers it necessary, the Office of the Attorney General shall petition the Supreme Court for an order to stop the execution of a transaction. Upon an ex parte showing of probable cause, the Supreme Court shall order stoppage of the transaction. When exigent circumstances require it, the Office of the Attorney General may make the aforesaid application for an order via telephonic communication with any sitting Justice of the Supreme Court at any time (to be followed by a written application). These orders are valid for 72 hours. There is a right to extend these orders for up to eight days.</p> <p>There is no provision for confiscation to be possible through civil process.</p> <p>Section 34 of the AML law provides for the avoidance of any instrument, the purpose of which is to fraudulently convey property and keep it from confiscation, if the Supreme Court determines that the instrument has been done for fraudulent purposes.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>The confiscation provision should be expanded and clarified so that confiscation of all proceeds of money laundering offenses, predicate offenses, instrumentalities and subject matter of money laundering offences should be possible.. In the event that the proceeds of crime or instrumentalities or subject matter of the offense are not available for confiscation the court should have the power to order confiscation of property of an equivalent value or the payment of a penalty sum equivalent to the value of property to be confiscated. There should be adequate procedures for the protection of innocent and bona fide third party interest.</p> <p>Palau should sign and ratify the Palermo Convention.</p>

	<p>The confiscation and provisional measures should extend to the confiscation, seizing and freezing of assets used for the financing of terrorism. The powers to freeze property assets should be extendable.</p>
<p>Financial intelligence units</p> <p>National authorities should create mechanisms whereby financial information relevant to the prevention of money laundering and terrorism finance is collected, analyzed, and disseminated to appropriate supervisory and law enforcement authorities. Financial institutions' suspicious transactions reports are an integral component of this mechanism.</p> <p>The typical process is one where the financial institutions are required to make suspicious activity reports, often through their national supervisors, to a financial intelligence unit (FIU or other national AML/CFT Competent Authority). The FIU acts as the central repository to gather information, primarily in the form of the suspicious activity reports, and turns this raw reporting into intelligence that is provided to the appropriate authority to support a national anti-money laundering effort.</p> <p>The overall effectiveness of fighting money laundering crime (and now terrorism finance) will often depend on the sharing of information and intelligence among several jurisdictions. This sharing of information is facilitated by interaction between FIUs, law enforcement agencies and supervisory agencies.</p>	
<p>Description</p>	<p>The AML law established the FIU. Section 15 of the AML establishes the FIU within the Office of the Attorney General. It provides that other agencies of the government may be assigned to assist the FIU by the President at the request of the Attorney General. A Coordinator was appointed on November 19, 2001. The Minister of Justice had indicated that when the need arises other officers would be assigned. While there is a power to issue regulations by the Attorney General pertaining to the duties and functions of the FIU no regulations have been issued. The FIU has indicated that it needed technical assistance to issue such regulations.</p> <p>The AML law provides that the FIU members may not concurrently hold any other public or private employment or hold or pursue any elective office in the Palau National Government any State Government, or engage in other assignments or activities, which might affect the independence of their position.</p> <p>Section 15(b) of the AML law provides that the FIU members shall be required to keep confidential any information obtained within the scope of their duties, even after cessation of those duties with the FIU. Such information can only be used for any purposes provided for by the AML law.</p> <p>Section 15 (d) of the AML law provides that the FIU shall receive the reports transmitted by the persons referred to in sections 10 and 19, i.e., suspicious transaction reports. It provides further that the FIU shall analyze the reports on the basis of the information at its disposal and shall gather, in particular from organizations and government ministries and agencies involved in combating organized crime, any additional information that may help to establish the origin of the funds or the nature of the suspect transactions forming the subject of the reports.</p> <p>Section 16 of the AML law provides for the general powers of the FIU, which are receiving, analyzing, and processing reports required pursuant to the AML law. However, there is no specific power for the FIU to disseminate the information to law enforcement agencies on its own initiative.</p> <p>The FIU has to submit an annual report to the President, the Minister of Justice, and the Olbiil Era Kelulau. The report shall provide an overall analysis and evaluation of the reports received and of money laundering trends.</p> <p>Section 16 of the AML law provides that all officials, employees, and agents of the national government or any other government shall keep confidential the information thus obtained, which may not be used for any purposes other than those provided for in the AML law.</p> <p>Section 17 gives the power to the FIU to have access to other information from any public authority or from any natural or legal person information and records within the scope of</p>

	<p>investigations conducted following the report of a suspicion of illegal activities. The FIU shall, upon request, be granted reasonable access to databases of all public authorities. In all cases, the use of information thus obtained shall be limited to the purposes of the AML law.</p> <p>Section 18 of the AML law gives the FIU the power, subject to a reciprocal arrangement with foreign governments, to exchange information with financial intelligence units of foreign countries responsible for receiving and processing reports of money laundering, provided that such exchanges are governed by confidentiality requirements substantially similar to those set out in the AML law. It also allows the FIU to comply with a request for information or transmission from a counterpart foreign financial intelligence unit if it is within the scope of the powers set forth in the reciprocal agreement, so long as such compliance is not in conflict with Palau law.</p> <p>Section 19 of the AML law also sets out the requirement for suspicious transactions reports and section 19 sets out how the reports are to be transmitted. In addition, the FIU by an advisory has set out the Form for reporting. The FIU has power to issue regulations but has not done so. The FIU is authorized pursuant to an investigation, to seize documents relating to money laundering offense and to monitor such accounts, subject to an order of the Supreme Court.</p> <p>The FIU has the power to seize documents during an investigation but has no inherent power to audit compliance with the AML law obligations (section 23 AML law).</p> <p>If the FIU considers it necessary, the Office of the Attorney General can petition the Supreme Court for an order to stop the execution of a transaction. It has no power to effect sanctions and penalties but the Attorney General has power to impose civil penalties against financial intermediaries for non-compliance with their verification, reporting and record keeping requirements (section 20 AML law).</p> <p>One of the sanctions that can be imposed under section 29 of the AML Law if a person has been found guilty of money laundering is the inability to carry on their business permanently or for five years. There is a loss of license for anyone who tips off.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>The FIU should be staffed and organized in such a way as to ensure that its functions are properly executed. The prohibition of FIU members from concurrently holding any other public employment or holding or pursuing any elective office in the Palau National Government, or State Government should be removed given the lack of resources in Palau.</p> <p>The FIU should have access to information of other public authorities to enable it to analyze the reports it receives. The FIU should <i>not</i> require a court order to do so.</p> <p>The FIU should also be authorized to enter into agreements with foreign FIUs to facilitate cooperation on terrorism financing.</p> <p>The AML law should be amended to give the FIU the power to disseminate information to law enforcement agencies on its own initiative or on request. Adequate safeguards as to the use and confidentiality of the information disseminated should follow such dissemination. It should be given the power to audit the financial intermediaries compliance with the AML law and any financing of terrorism provisions and to request that further documentation be produced as need be. The FIU should have the power to undertake research and advisory activities relating to money laundering and terrorism financing and to devise training materials and programs and to educate the public. In order to carry out this wide range of tasks, it is likely that the FIU will need technical assistance.</p> <p>The FIU and its information should have adequate legal protection from legal suits and legal process.</p> <p>The FIU should have the power to ensure compliance. At a minimum, the FIU should have the power to conduct on-site inspections to check on compliance. If there are serious deficiencies, the FIU should have a wide range of enforcement tools.</p>
<p>International Cooperation in AML/CFT matters</p> <p>Laws should permit multilateral cooperation and mutual assistance (including investigation, prosecution, and extradition) in AML/CFT matters based on accepted international practices. (See FATF 3, 33, 34, 35, 36, 37, 38, 39, 40, I and V).</p>	

<p>Description</p>	<p>Palau introduced measures for mutual legal assistance through the Mutual Assistance in Criminal Matters Act 2001. The Mutual Assistance in Criminal Matters Act 2001 provides both the procedures and standards for submitting requests to Palau and for Palau to request for assistance. The provisions in the Mutual Assistance in Criminal Matters Act 2001 are subject to any agreement that Palau may enter into with that country.</p> <p>Palau permits mutual assistance for all serious offenses which is defined to mean any offense for which the punishment is imprisonment of more than one year and an offense against the law of a foreign state in relation to acts or omissions which had it occurred in Palau would have been a criminal offense punishable by imprisonment of more than one year. This includes money laundering. Assistance can be given where the person is charged with money laundering or where he is charged with both money laundering and the predicate offense.</p> <p>Assistance can only be given to a foreign state if there is an assurance that the requesting foreign state covers all the costs associated with the request. It can refuse a request if it is prejudicial to the sovereignty, security or other essential public interest of Palau (section 5, Mutual Assistance in Criminal Matters Act 2001).</p> <p>Assistance can be given for all investigations and proceedings and can relate to the evidence gathering orders, search warrants, consensual transfer of detained persons, detention of persons transferred to Palau (with appropriate safe conduct assurances), enforcement of restraining orders, confiscation orders and the location of proceeds of crime. The orders are available for all serious offenses. (Subchapter II of the Mutual Assistance in Criminal Matter Act 2001). There is no specific provision enabling cooperation in controlled deliveries but as cooperation in investigations is allowed this would include cooperation in controlled deliveries.</p> <p>Section 16 of Mutual Assistance in Criminal Matters Act 2001 allows for the sharing of confiscated property.</p> <p>The Foreign Evidence Act 2001 provides for the admissibility of certain types of evidence obtained overseas. The Extradition and Transfer Act 2001 allows for the extradition of criminals in money laundering cases.</p> <p>The provisions of these Acts have not been utilized yet. All requests for assistance have been from the United States, which have been handled by a special arrangement between the United States and Palau. (COMPACT)</p> <p>The Attorney General and the Ministry of State handle requests for foreign assistance.</p>
<p>Assessment</p>	<p>COMPLIANT</p>
<p>Comments</p>	<p>The framework in Mutual Assistance in Criminal Matter Act 2001 sets out Palau’s ability to respond to foreign requests and to provide meaningful support to foreign criminal proceedings. However mutual assistance in financing of terrorism is not specifically provided for and should be included. As the AML law is new, it is yet to be seen as to whether its provisions will be workable in practice. It is proposed that Palau prepare regulations that set out detailed procedures especially with regards to enforcement of foreign restraining and confiscation orders.</p> <p>Extradition should cover financing of terrorism, too.</p>
<p>Controls and Monitoring of Cash Transactions</p> <p>(For information only, not assessment)</p>	
<p>Describe controls on the import and export of bank notes</p>	<p>Palau requires the reporting of import of currency exceeding \$5,000. this is not required by law.</p> <p>Palau is of the view that it would not be timely now to imposing a cash reporting without having considered whether such reporting would be appropriate taking into account the types and levels of cash activity in Palau. They would require assistance in undertaking such a study. However it is a requirement that all domestic and international transfer are to be effected through the banks and the FIU has the power under the AML Law to have access to such records during investigations, subject to court order.</p>

Describe procedures for monitoring and recording cross-border movements of large amounts of cash	The Customs monitor the cross-border movements of large cash amounts. There is, however, no specific requirement under the AML law to report cross-border cash movements in or out Palau.
Describe factors which influence the use of cash in transactions	The mission found from the meetings with the banks that Palau is largely cash based with some usage of checks.

Part 2: Assessing the AML/CFT in prudentially-regulated sectors

Module 1—AML/CFT in the banking sector

Table 5. Detailed assessment of AML/CFT elements for banking supervision

<p>Organizational and Administrative Arrangements</p> <p>The supervisor determines that banks have in place policies and procedures that are adequate to deter improper use by criminal elements. Measures should provide for prevention and detection of money laundering and other criminal activity, as well as ensure appropriate reporting of suspected money laundering activities. Supervisory and institutional arrangements below are consistent with FATF Recommendation 19, 26 and 27 referring to the role of the supervisor and establishment of internal policies, procedures, audit and training programs to deter money laundering. The supervisor promotes high ethical and professional standards by banks.</p>	
Description	<p>The legal framework to detect and prevent money laundering is detailed in Part I.</p> <p>The FIC under the FIA has general supervisory powers to ensure banks' compliance with provisions of the FIA and this includes section 48 of the FIA that provides that no financial institution shall conceal, convert, or transfer cash or other property, knowing that such property is derived from criminal activity, for the purpose of concealing or disguising the illegal origin of the property or shall knowingly assist any person who is involved in such activity to evade the legal consequences of his or her action. However, as the FIC has just been established it has not issued any guidance on AML matter or exercised its supervisory powers. These supervisory powers can only be exercised over financial institutions licensed under the FIA.</p> <p>The FIC has the powers under section 44 of the FIA to ensure that all persons elected or appointed as administrators of a financial institution must be of good repute and must meet the criteria established by regulation of the FIC regarding qualifications, experience, and integrity. However, no regulations have been made yet. Section 45 of the FIA provides that a person shall not be eligible to become a member of the board of directors of a Palau financial institution, or shall be relieved of his or her membership on the board of directors if he or she has been convicted of a felony or a crime of moral turpitude.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	<p>At a minimum, the FIC should introduce the following:</p> <ul style="list-style-type: none"> • Guidelines on internal controls, policies and procedures for the prevention and deterrence of money laundering; • Regulations on “fit-and-proper” tests for controlling shareholders and management.
<p>Customer Identification and Due Diligence</p> <p>The supervisor determines that as part of their anti-money laundering program banks have documented and enforced policies for identification of customers and those acting on their behalf. The information requirements on</p>	

customers need to be commensurate with the assessed risk of money laundering posed by those customers. The customer identification requirements are consistent with the Basel Committee paper on Customer Due Diligence for Banks and FATF Recommendations 10 and 11.	
Description	<p>The legal framework for customer due diligence is detailed above in Part 1 .</p> <p>The FIU has no supervisory powers or power to audit compliance with the AML law. The FIC has supervisory authority over the banks to ensure that they comply with the provisions of the FIA including section 48 which is the provision preventing money laundering in financial institutions.(see above). The FIA does not require customer identification.</p> <p>In practice, some banks have established customer due diligence procedures especially the FDIC banks that have to comply with U.S. laws.</p> <p>However, banks have not received any guidance on the implementation of the customer due diligence requirements under the AML law.</p>
Assessment	NON-COMPLIANT
Comments	The FIU should be given additional powers and the power to audit compliance and conduct on-site inspections. The FIU should prepare regulations for the implementation of customer due diligence requirements under the AML law.
<p>Monitoring and Reporting of Suspicious Activities</p> <p>The supervisor determines that banks have formal procedures to recognize and report potentially suspicious transactions. Banks and FIUs should establish and regularly revise systems for detection of unusual or suspicious patterns of activity that provide managers and compliance officers with timely information needed to identify, analyze and effectively monitor customer accounts.</p>	
Description	<p>The legal framework for monitoring and reporting of suspicious activities is detailed above in Part 1.</p> <p>The AML law sets out in detail the requirement of reporting suspicious transactions. It provides that financial intermediaries shall be required to report transactions carried out even if it is not feasible to defer the execution of transactions or if it became clear only after completion of a transaction that it involved a money laundering offense. It provides that reports of suspicions of violations of money laundering shall be transmitted to the FIU by a confidential communication in writing. Reports of suspicions of violations communicated by telephone shall be confirmed by a confidential communication in writing within the shortest reasonable time. Such reports shall, as appropriate, indicate: the reasons why the transaction was executed or the time limit within which the transaction is to be executed. It requires the FIU to immediately acknowledge receipt of such reports.</p> <p>The FIU has through an Advisory issued guidance on the Form for reporting and what should be reported.</p> <p>However, the FIU has no power to determine that banks have procedures for reporting suspicious transactions.</p> <p>There is a tipping off provision in the AML law, but again the FIU has no supervisory power to ensure that banks and their employees are not tipping their customer off.</p> <p>There is no specific power that banks give special attention to business relations and transactions with entities from countries that do not comply with AML and CFT measures, but these can be set out in regulations.</p> <p>The FIU has through an Advisory required banks to reports whether they suspect any funds are related to terrorists and terrorist organizations listed by the U.S. and the U.N. and report these to the FIU. Administratively the FIU has checked compliance with these requirements.</p>
Assessment	MATERIALLY NON-COMPLIANT
Comments	The FIU had indicated that it requires assistance to come up with more detailed regulations to financial intermediaries on suspicious transactions reporting and the banks have indicated that they require training in recognizing suspicious transactions. However, the FIU and the banks have stated that as Palau is small and despite the lack of regulations and other measures, all suspicious transactions are reported to the FIU..

Record Keeping, Compliance and Audit	
The supervisor determines that banks have formal record keeping procedures regarding customer identification and individual transactions and the retention period. Record keeping procedures should be regularly reviewed for compliance with applicable laws and internal policies. The criteria used are consistent with FATF Recommendation 12.	
Description	The legal framework for record keeping is detailed in Part I. The FIU has no power to check compliance with these requirements. Some of the financial intermediaries interviewed had in place requirements for record keeping especially the FDIC regulated banks.
Assessment	MATERIALLY NON-COMPLIANT
Comments	The FIU should prepare regulations on the implementation of the record keeping requirements under the AML law.
Cooperation with supervisors and competent authorities	
The supervisor is able, directly or indirectly (<i>including through a Financial Intelligence Unit</i>), to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.	
Description	Pursuant to section 18 of the AML law, the FIU has the power to share with foreign FIUs any information it has. The information is subject to conditions in the agreement between the two FIUs.
Assessment	COMPLIANT
Comments	Any sharing of information should be subject to safeguards as to the confidentiality and use of such information.
Licensing and authorizations	
The licensing authority banking activities should take the necessary legal or regulatory measures to ensure that fit-and-proper persons control financial institutions. Measures should prevent control or acquisition of a material participation in financial institutions by criminals or their confederates. The licensing requirements also conform to FATF Recommendation 29.	
Description	The FIC has the powers under section 44 of the FIA to ensure that all persons elected or appointed as administrators of a financial institution must be of good repute and must meet the criteria established by regulation of the FIC regarding qualifications, experience, and integrity. However, no regulations have been made yet. Section 45 of the FIA provides that a person shall not be eligible to become a member of the board of directors of a Palau financial institution, or shall be relieved of his or her membership on the board of directors if he or she has been convicted of a felony or a crime of moral turpitude.
Assessment	LARGELY COMPLIANT
Comments	The FIC should prepare regulations relating to the fit and proper test for those controlling banks, those who are its directors, and senior management.

C. Recommendations and authorities' response to the assessment

Recommendations

Table 6. Recommendations to improve implementation of the AML/CFT Measures

Topic	Recommended Action
Part 1: AML/CFT in the legal and institutional framework	
Suggested actions for the legal and institutional arrangements	
Organizational, Administrative, Capacity Building Considerations	<p>The FIU should be properly established and resourced and trained. The FIU should be vested with adequate compliance, inspection, and enforcement powers for the AML law. Existing AML provisions should be implemented beginning immediately.</p>
	<p>The FIC would have the supervisory role over the policies and procedures that banks have in place and for implementing fit and proper test for all the relevant persons.</p>
	<p>Training for FIU, banks, AG and Police on anti-money laundering matters</p>
	<p>The FIB and the Registrar of Corporations should ensure that entities that they register do not have serious criminals holding significant investments and from holding any management functions.</p>
Legal	<p>Sign and ratify the Palermo Convention and the UN Convention on Suppression of Financing of Terrorism. Pass legislation on the financing of the terrorism</p>
	<p>Amend the AML law to:</p> <ul style="list-style-type: none"> • Lower the threshold when identifying casual clients. Impose a requirement that financial intermediaries identify all complex or unusual transactions and complex or unusual patterns of transactions, transactions that have no apparent or visible economic lawful purpose and to examine the background of such transactions and to send such information to the FIU as a suspicious transactions; • Prohibit anonymous accounts; • Require customer identification for wire transfers; • All records should be routinely available for the inspection of the FIU without the need for an order of the Supreme Court; • Introduce requirement for record keeping for all transactions for five years after the termination of the account or business relationship. Records kept should be sufficient to permit the reconstruction of individual transactions so as to provide evidence for prosecution of criminal behavior. The records should at a minimum include the customers name, address or other identifying information normally recorded by the intermediary), nature and date of the transaction, type and amount of currency involved and details of the account. Remove the threshold of \$10,000 for the record keeping requirement for customer identification; • Clarify the suspicious transaction reporting requirement in sections 10 and 19; • Enable the FIU to be sent suspicious transactions reports without having to go to the Supreme Court. The FIU should have access to reports of all transactions made in cash or bearer securities in excess of \$10,000 or its equivalent in foreign cash or bearer security that are kept by financial intermediaries pursuant to section 5 of the AML law;

Topic	Recommended Action
	<ul style="list-style-type: none"> • Extend the overriding of secrecy to all reports made under the AML law especially for reports made pursuant to section 19 of the AML law; • Extend the tipping of provision in section 12(d) to disclosures made under section 19 of the AML law to prevent ambiguity, as well as to any person who has knowledge that a suspicious transaction report has been made; • Require financial intermediaries to include originator information and related messages on funds transfer that should remain through the payment chain; • Extend the sanctions in section 30 for non-compliance with section 19 of the AML Law to prevent ambiguity; • Set out the predicate offenses clearly. The predicate offense should also extend to those committed extraterritorially; • Set out the <i>mens rea</i> element for all limbs of the money laundering offense clearly; • Extend the confiscation provision to cover the confiscation of all proceeds of money laundering offenses and the predicate offense, instrumentalities and subject matter of money laundering offences. In the event that the proceeds of crime or instrumentalities or subject matter of the offense are not available for confiscation the court should have the power to order confiscation of property of an equivalent value or a penalty sum equivalent to the value of property to be confiscated; • Include adequate procedures for the protection of innocent and bona fide third party interest.
	<p>The FIU to be vested with the power to:</p> <ul style="list-style-type: none"> • Audit compliance with the AML law including the power to request for further information without the need for a court order; • At a minimum, the FIU should have the power to conduct on-site inspections to check on compliance. If there are serious deficiencies, the FIU should have enforcement powers; • Disseminate information to law enforcement agencies on its own initiative or on request. Adequate safeguards as to the use and confidentiality of the information disseminated should follow such dissemination; • Undertake research and advisory activities relating to money laundering and to devise training materials and programs; • Educate the public; • have access to information from other public authorities to enable it to analyze suspicious transactions. <p>The prohibition of FIU members from concurrently holding any other public or private employment or holding or pursuing any elective office in the Palau National Government any State Government should be removed given the lack of resources in Palau.</p> <p>The FIU should issue regulations on the implementation of the AML law to the financial intermediaries.</p> <p>The FIU and its information should be adequately protected from legal suits and legal process.</p>
	<p>Regulations under the Mutual Assistance in Criminal Matters Act 2001 should be issued that set out detailed procedures especially with regards to enforcement of foreign restraining and confiscation orders.</p>

Topic	Recommended Action
Part 2: AML/CFT in prudentially-regulated sectors	
Suggested actions for AML/CFT in the banking sector	
Supervisory	The FIC to prepare regulations on the internal controls and procedures relating to AML law obligations.
Fit and Proper test	The FIC to prepare regulations for “fit-and-proper” tests for controlling shareholders and management of financial institutions under its purview.

Authorities’ response to the assessment

40. The authorities’ response to the assessment is as follows:

“The Republic of Palau is committed to bringing Palau into compliance with international banking and anti-money laundering standards. The recommendations of the IMF Module II assessment team will be taken into very serious consideration and either incorporated into proposed legislative changes to be presented to the National Congress for adoption or into regulations for implementation, whichever is appropriate. Please understand, however, that Palau does have limited resources and expertise and will be in need of technical assistance where necessary in order to implement proper banking regulation and supervision.”

Table 7. Compliance with the FATF Recommendations

FATF Recommendations (40 + 8)	Grading					Remarks
	C	LC	MNC	NC	Not Assessed	
The FATF 40 Recommendations						
1 – Ratification and implementation of the Vienna Convention	X					
2 – Secrecy laws consistent with the 40 Recommendations		X				Section 25 AML Law
3 – Multilateral cooperation and mutual legal assistance in AML	X					Mutual Assistance In Criminal Matters Act, Extradition and Transfer Act
4 – Money laundering a criminal offence (Vienna Convention)	X					Section 3 AML Law
5 – Knowledge of money laundering a criminal offence (Vienna Convention)		X				Section 3 AML Law
6 – Criminal liability of corporations—and their employees	X					Section 29 AML Law
7 – Legal and administrative conditions for confiscation (Vienna Convention)		X				Mutual Assistance In criminal Matters Act, Extradition and Transfer Act
8 – Recommendations 10-29 apply to non-bank financial institutions		X				Definition of financial institutions in AML Law
9 – Recommendations 10-21&23 apply to financial services	X					
10 – Prohibition of anonymous accounts				X		
11 – Obligation of reasonable measures for customer identification		X				Section 7, 8, 9 AML Law
12 – Comprehensive record keeping (5 years) for transactions			X			Section 5, 11 AML Law
13 – Attention paid to AML risk from new technologies					X	Palau is a small jurisdiction where use of new technology not evident
14 – Detection and analysis of unusual or large transactions				X		
15 – Reporting requirement for suspicious transactions	X					Section 10, 11 AML Law
16 – Legal protection for good faith reporting to competent authority	X					Section 21 AML Law
17 – No tipping off customers of reports to competent authority	X					Section 12(d) and 31 AML Law
18 – Compliance with instructions for suspicious transactions reporting			X			Section 20 AML Law
19 – Internal policies, procedures, controls, audit, and training programs	X					Section 13 AML Law
20 – AML rules and procedures apply to branches and subs abroad					X	No branches and subs abroad
21 – Special attention given to problem countries				X		
22 – Detection and monitoring of cross-border transportation of cash					X	
23 – Centralization of data on currency transactions					X	
24 – Support to the replacement of cash transfers					X	
25 – Prevention of unlawful use of shell corporations					X	
26 – Adequate AML programs in supervised banks/financial institutions					X	Too early to be assessed. Power is with FIC

FATF Recommendations (40 + 8)	Grading					Remarks
	C	LC	MNC	NC	Not Assessed	
27 – Administrative regulation of other professions dealing with cash		X				Definition of financial intermediary, section 14, AML Law
28 – Guidelines for suspicious transactions detection			X			
29 – Preventing control of financial institutions by criminals		X				Section 44, 45 FIA and Corporations Act and Foreign Investment Act
30 – Recording of international flows of cash					X	
31 – Information gathering and dissemination about AML				X		AML laws just introduced
32 – International exchange of information relating to suspicious transactions, and to persons or corporations involved	X					Section 15 AML Law
33 – <i>Bilateral or multilateral agreement on information exchange when legal standards are different</i>	X					Mutual Assistance in Criminal Matters Act
34 – <i>Bilateral and multilateral agreements and arrangements for mutual assistance</i>	X					Mutual Assistance in Criminal Matters Act
35 – <i>Ratification and implementation of other international conventions on money laundering</i>				X		Palermo Convention and Terrorism Convention not signed or ratified
36 – <i>Cooperative investigations among countries' authorities</i>	X					Mutual Assistance in Criminal Matters Act
37 – <i>Definition of procedures for mutual assistance in criminal matters</i>	X					Mutual Assistance in Criminal Matters Act
38 – <i>Authority to take expeditious actions in response to foreign countries' requests</i>		X				Mutual Assistance in Criminal Matters Act
39 – <i>Mechanisms to avoid conflicts of jurisdiction</i>		X				
40 – <i>Money laundering an extraditable offence</i>	X					Extradition and Transfer Act
FATF eight special recommendations to combat terrorist financing						
<i>SR1 – Take steps to ratify and implement relevant United Nations instruments</i>			X			Anti terrorism bill drafted to enable ratification
<i>SR2 – Criminalize the financing of terrorism and terrorist organizations</i>				X		
<i>SR3 – Freeze and confiscate terrorist assets</i>				X		Anti terrorism bill drafted
<i>SR4 – Report suspicious transactions linked to terrorism</i>	X					Advisory issued by FIU
<i>SR5 – provide assistance to other countries' terrorist financing investigations</i>				X		Anti terrorism bill drafted
<i>SR6 – impose AML/CFT requirements on alternative remittance systems</i>				X		Inclusion of money remitters in definition of financial intermediaries, Section 14 AML Law, and Anti terrorism bill drafted
<i>SR7 – Strengthen customer identification measures for wire transfers</i>				X		Anti terrorism bill drafted
<i>SR8 – Ensure that entities, in particular nonprofit organizations, cannot be misused to finance terrorism</i>			X			Corporation law has possible provisions but no requirements imposed.