



Financial System Review - June 2015





Banco Central de Timor-Leste

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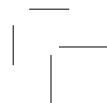
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Preface

This inaugural *Financial System Review* is a further step in the implementation of the Master Plan for Financial Sector Development in Timor-Leste, launched a year ago in August 2014. A key theme in the Master Plan is the need for monitoring of progress. Publication of an annual *Financial System Review* was proposed as one of the means by which that could be done.

The purpose of the *Financial System Review* is to review and report on the Timor-Leste financial system from two standpoints:

- ❖ the stability of the financial system, including potential risks to its stability; and
- ❖ progress towards the sound development of the financial system.

The *Financial System Review* is focused mainly on those aspects of the financial system for which Banco Central Timor-Leste has regulatory and policy responsibility, but will also take a whole-of-system view. This Report covers the period up to June 2015.

I am pleased to be able to report that, over the past year, Timor-Leste's financial system has been stable. Good progress has also been made on implementing a number of elements of the Master Plan. Two highlights have been the launch in November 2014, by President H.E. Mr Taur Matan Ruak, of the National Program on Financial Education and, in April 2015, of the R-Timor electronic interbank payments system. Alongside the latter development, Timor-Leste's banks have made significant advances with launches of telephony-based banking and payment services.

On the other hand, an aspect of Timor-Leste's financial development that the *Financial System Review* makes clear is lagging is access to, and the uptake of, credit by Timor-Leste's firms and households. In recent years, there has been steady growth in the deposit-taking side of financial institutions' balance sheets, but very little expansion of lending. This will need to be a priority issue in the year ahead.

Mr Abraão F. de Vasconcelos
Governor



1. Overview

Onshore (non-oil) economic activity recovered in 2014, from a slow-down in 2013. This has provided Timor-Leste's financial system with supportive macroeconomic conditions. At the same time, the strengthening of the USD since 2013 has increased the price-competitiveness of imports, making the establishment, and expansion, of local production – and the opportunities for local financial institutions to finance that – more challenging. Meanwhile oil prices have fallen sharply. However, Timor-Leste's on-shore economy is buffered from the impact of reduced oil revenues, with these being absorbed by Timor-Leste's foreign-invested Petroleum Fund.

Timor-Leste's financial system comprises mainly four banks, three of which are branches of large international banks (ANZ, Bank Mandiri and CGD/BNU) and one a government-owned local bank (BNCTL). Overall, the banking system has grown reasonably strongly during the past year or two, although much more on the deposit-taking than lending side of the business. The two micro-finance institutions have also grown during the period, albeit one by more than the other.

Timor-Leste benefits from the financial and operating strengths that the three international banks bring to Timor-Leste, although they can also be a conduit for the transmission of financial instability from abroad. BNCTL is considering possible means by which the latter risk can be reduced, possibly by requiring international banks with a business presence in Timor-Leste to be incorporated in Timor-Leste. BNCTL is also

mindful of the need for the international banks' operations in Timor-Leste to continue to develop their businesses in ways that contribute to their respective international group performance objectives, so as to maintain the benefit of long-term head office commitment to those operations.

Meanwhile, BNCTL, Timor-Leste's only 'local' bank continues to develop. While profitability in the year to December 2014 was down on the previous year's result, BNCTL retains a good financial (capital and liquidity) base, as well as a large customer base, from which it can achieve further growth and development. BNCTL's main challenges relate to developing the operational capabilities that are needed to support the growth of its business. (Unlike its three competitors, BNCTL does not have access to the systems and capabilities of an international banking group.)

The micro-finance sector has also expanded during the past two years, although with virtually all of the expansion accounted for by one institution (Tuba Rai Metin). Timor-Leste's two insurance companies similarly have progressed. Both companies reported profits in 2014-2015, following losses in their early years of operation, and the shareholders in both provided additional capital, signifying commitment to further development of the insurance sector in Timor-Leste.

A notable area of recent development has been progress by all four banks in Timor-Leste towards the roll-out of branchless banking facilities. The

business models being adopted differ from bank to bank. Some are focused on provision of mobile cash-in/cash-out facilities and others more on provision of electronic payment facilities. But all will make useful contributions to extending the delivery of banking services to Timor-Leste's firms and households, particularly to those located outside of the main centres.

BCTL in February 2015 issued a circular letter to banks in Timor-Leste providing guidelines on the use of agents in branchless banking. These address the arrangements that must be in place to provide a basis for the public to transact with confidence with banks' agents. Those include requirements in relation to systems and audit trail, agent identity, agent selection, bank responsibility for its agents, transparency and a customer complaints process. They build on the policy in Timor-Leste that branchless, including telephony-based, banking is to be bank based.

Also pleasing to see is some increase in the number of points of presence of the banks, with increases in both the number of branches and of ATMs. Deposit account numbers have also increased significantly. Further progress in extending the use of financial services is being fostered through the National Program on Financial Education which was launched by the President in November 2014, and a National Strategic Plan (NSP) for Financial Literacy being developed by BCTL. The latter, which is expected to be launched shortly, provides a roadmap, covering the period 2016-2020, to improve the level of financial literacy in the population and

to improve the ability of people to manage their personal financial affairs.

Less positive has been lagging growth in lending, compared with in deposit-taking, by Timor-Leste's banking system. While maintaining the soundness of lending remains fundamental, lending growth that persistently lags behind deposit growth means that the financial system is not contributing to Timor-Leste's economy to the extent that it could.

This underscores the importance of the progress being made, under the leadership of the Ministry of State, Coordinator of Economic Affairs, on secured lending reform. This will enable moveable property to be offered as collateral by borrowers in support of their applications to borrow (and, prospectively, the possibility of similarly using immovable property as collateral, once land titles have been clarified). These steps will need to be complemented by lenders developing secured lending products, and by actively seeking out the new lending opportunities that will be made possible by these reforms.

Initial steps also are being taken this year, since 26 March 2015 under the leadership of the Ministry of Finance (prior to that SEAPRI), to establish a National Development Bank for Timor-Leste. This proposal is being developed on the basis that the role of a National Development Bank is to complement rather than substitute for private banking, and hence with a view to co-financing and co-ownership possibilities.



2. The Economic and Financial Environment

The financial system both contributes to and depends on the wider economic performance of the economy. This chapter provides a brief summary of the economic and financial environment within which Timor-Leste's financial system currently is operating. A more comprehensive review of recent macroeconomic developments is provided in Banco Central Timor-Leste's 2014 *Annual Report*.

The domestic economy

Over the past three years, growth of the Timorese domestic economy has averaged about 4.5 per cent per annum, albeit with a slow-down in 2013 (Table 1).¹ This has provided the financial system with a reasonably stable environment within which to operate. However, growth has been from a low base. This leaves output per capita (excluding oil) at a low level compared with that of other similarly small Asia-Pacific countries, and potential for substantial further growth in the medium-long run.

Also, the government remains the largest funder of onshore economic activity, with the

financial system continuing to play only a small role in channeling domestic savings to private investment and other domestic spending. The ratio of government spending to non-oil GDP in 2015 is projected at 127 per cent, whereas the ratio of (the total stock of) lending by financial institutions to non-oil GDP is yet to reach 15 per cent. The financial system continues to channel overseas most of the savings mobilized within Timor-Leste.

In recent years (since 2011) estimates of the rate of credit expansion (averaging 14.8 per cent per annum) have been only a little above the rate of growth in (nominal) GDP, resulting in only a small increase in the ratio of financial sector credit to GDP (Table 1). Also, recent data on bank lending indicates that credit expansion may have fallen short of earlier estimates. Bank loans outstanding in June 2015 were only 8.6 per cent above the level of 21 months earlier in September 2013. These data point to considerable potential for financial deepening to support growth of the economy. With the economy still at an early stage of development, and financially shallow, it is vital that credit is readily available to finance sound borrowing propositions.

¹ Here the domestic economy is taken as the non-oil economy, given that the oil sector operates largely as an enclave that mostly is disconnected from the on-shore economy. Oil sector revenues are channeled to the Petroleum Fund, which is invested almost entirely abroad, and the sector's workforce comprises mostly expatriates who mostly operate on a 'fly in, fly out' basis. There are few connections, therefore, between the oil sector and Timor Leste's financial system.

Table 1: Summary measures of macroeconomic stability and performance

	2011	2012	2013	2014	2015
	Percentage (unless otherwise indicated)				
Output					
Nominal GDP (annual growth) ¹	42.2	17.6	-17.8	15.6*	10.6*
Real Total GDP (annual growth) ¹	12.6	5.2	-13.9	-10.2*	10.2*
Real Non-oil GDP (annual growth) ²	9.5	6.4	2.8	6.0*	4.1*
Non-oil GDP/Total GDP (ratio) ¹	22.3	22.6	26.9	35.7*	36.2*
Inflation					
CPI inflation (annual rate) ²	17.5	11.7	4.0	-0.1	0.4
Government expenditure \$(000)3					
Government expenditure as % of:	1,097	1,198	1,081	1,367	1,570
- GDP ¹	23.9	24.8	26.0	33.0*	30.9*
- Non-oil GDP ²	107.2	110.1	96.7	115.4*	127.3*
Exchange rate (end yr)					
- versus Indonesian rupiah (IDR/USD) ⁴	9,070	9,645	12,178	12,417	13,338
- versus Australian dollar (USD/AUD) ⁵	1.0253	1.0368	0.8919	0.8200	0.7510
Financial sector					
Credit: ⁶	\$133m	\$160m	\$182m	\$192m	\$212m
- growth (annual rate)	21.1	20.5	13.6	5.5	13.2
- relative to non oil GDP (ratio)	13.0	14.7	16.3	16.2	17.2
Deposits					
- growth (annual rate)	9.2	26.2	22.7	19.9	20.4
Oil price \$ (year end)⁷	\$107.97	\$109.64	\$110.63	\$62.16	\$64.56

* = estimate

Sources:

¹ Timor-Leste National Accounts for 2002-2013, Ministry of Finance, General Directorate of Statistics, except for 2014 & 2015 which are IMF projections (<http://www.imf.org/external/np/sec/pr/2014/pr14478.htm>)² Timor-Leste National Accounts for 2002-2013, Ministry of Finance, General Directorate of Statistics³ Government of Timor-Leste transparency portal and 2016 BB1⁴ <http://www.currency-converter.org.uk/currency-rates/historical/table/USD-IDR.html>, as at 7 July for 2015⁵ <http://www.ozforex.com.au/forex-tools/historical-rate-tools/historical-exchange-rates>, as at 7 July for 2015⁶ BCTL monetary and financial statistics and Timor-Leste National Accounts for non-oil GDP⁷ Oil price https://ycharts.com/indicators/brent_crude_oil_spot_price_imf, as at 31 May for 2015.

Realizing the potential for financial development in Timor-Leste, whilst also maintaining financial stability, will require continued progress on strengthening the policy foundations needed for sound lending (contract enforcement and the ability of lenders to take collateral to secure their lending).² It will also require lending institutions actively to seek out new lending opportunities capable of being assessed as credit-worthy. This is against a backdrop of substantial amounts of lending some years earlier that became, and remain, non-performing, and risk averseness on the part of lenders that has ensued from that. This risk-averseness still lingers, given continuing weaknesses in the legal setting for lenders' to be able to secure loan repayments.

Table 2: Commercial bank outstanding credit to the private sector

	2011	2012	2013	2014	2015 (March)
Business lending (\$ thousands)	76,173	90,868	103,325	95,273	101,381
Share of business lending	58.0%	58.3%	58.4%	53.9%	54.3%
Lending to individuals (\$ thousands)	55,224	64,929	73,532	81,428	85,247
Share of lending to individuals	42.0%	41.7%	41.6%	45.9%	45.7%
Total (\$ thousands)	131,387	155,797	176,857	176,701	186,628

One reflection of that risk averseness amongst lenders has been a shift, notable since 2014, in the balance between business and personal lending by the banks (Table 2). This shift reflects that lending to individuals, 'secured' against a salary directly credited to the borrower's bank, has been found by the banks to be comparatively lower-risk lending.

International developments

Oil price

A major development during 2014-15 affecting Timor-Leste has been the sharp fall in the price of oil – from USD110 at end 2013 to USD64 currently (Table 1). Petroleum production accounts for the majority of Timor-Leste's total GDP.

The domestic – or non-oil – economy, and hence Timor-Leste's financial system, however, has been sheltered from this development, at least for the short- to medium-term. This is because petroleum revenues are channeled to Timor-Leste's Petroleum Fund, meaning that the decline in those revenues has been absorbed by slower growth in the Fund, rather than by reduced domestic income and expenditure.

If the current decline in petroleum revenues was to become long-lasting, however, that would underscore the need for private

² Credit expansion at a rate significantly above the rate of growth in nominal GDP in more developed economies tends to indicate possible future financial instability. However that is not necessarily the case in economies that are financially shallow and with correspondingly greater potential for financial and economic development.

domestic economic activity to take over as the main engine of economic growth, and for the financial system, correspondingly, to play a stronger role than hitherto in the financing of domestic investment and development.

Exchange rate

Another headwind for Timor-Leste's economy has been the strengthening since mid-2011 of the USD, Timor-Leste being a 'dollarized' economy. This USD appreciation has increased the price-competitiveness of goods imported from Indonesia and Australia, Timor-Leste's two nearest neighbors, by about 25 to 30 per cent (all other things remaining equal). This makes establishment, and expansion, of local production – and the opportunities for local financial institutions to finance that – more challenging.

However this loss of competitiveness is only one of a number of factors bearing on Timor-Leste's ability to harness its productive potential. Currency appreciation is also resulting in a fall in the rate of CPI inflation and, with that, slower rates of increase in domestic costs, which helps competitiveness.

International financial (in)stability

Also relevant to any assessment of Timor-Leste's financial system are the economic and financial conditions in the home countries of the international institutions that operate in Timor-Leste. These are Australia (the home country of ANZ Banking Group Limited); Indonesia (the

home country of Bank Mandiri) and Portugal (the home country of Caixa Geral de Depósitos (CGD), which trades in Timor-Leste as BNU Timor - Grupo Caixa Geral de Depósitos).

Economic and financial conditions in Australia and Indonesia currently are stable, and provide a stable backdrop for the ANZ Banking Group and Bank Mandiri operations in Timor-Leste. Financial conditions in Portugal, however, have been more fragile. The latest IMF assessment of financial stability in Portugal is that:

The banking system as a whole remains adequately capitalized, with decreasing reliance on Eurosystem financing, but loan performance has continued to deteriorate. Non-performing loans increased to 12.3 per cent at the end of March, putting further pressure on already weak profitability as banks absorb large impairment expenses and high operating costs. (Source: IMF News Release 15/372, IMF Executive Board Concludes Second Post-Program Monitoring with Portugal, August 6, 2015.)

A reminder of the potential for instability in Portugal has also been provided by the instability in late June and early July 2015 in Greece. While the immediate crisis in Greece has been resolved, fragility, and hence some risk remains of contagion to other European countries with weakened economies and financial systems. Portugal is one of the lower-rated countries in Europe, with a rating in April 2015 of BB (Table 3).



3. Timor-Leste's Financial System

This chapter provides an update on the financial institutions that comprise Timor-Leste's financial system.

Timor-Leste's financial system includes:

- three banks that are branches of international banks.
- one local bank, owned by the Government of Timor-Leste.
- two insurance companies that are incorporated in Timor-Leste but owned from abroad.
- nine money transfer operators, licensed by the BCTL.
- two micro-finance institutions, with applications for Other Deposit-taking Institution (ODTI) licenses pending.
- a number of financial co-operatives/credit unions, some of which operate under the auspices of Federcao Cooperativa Credito Hanai Malu (FCCHM).
- village savings groups.

Data on the geographic spread of the points of access to financial services provided by these institutions across Timor-Leste are provided in Appendix Table 4.

Timor-Leste's banks

The international banks

Timor-Leste has four banks, three of which are

branches of foreign-incorporated banks (ANZ Banking Group Limited, Mandiri Bank and CGD/BNU). The remaining bank, BNCTL, is incorporated in, and owned by the Government of, Timor-Leste.

ANZ Banking Group and Mandiri Bank are well-rated banks based in jurisdictions that currently are economically, financially and politically stable (Australia and Indonesia, respectively). These banks' credit ratings and the sovereign ratings of their home countries are shown in Table 3. Currently the branches in Timor-Leste of these banks can be assessed as not representing a financial stability risk for Timor-Leste.

CGD is based and incorporated in Portugal. The majority of its business also is in Portugal. CGD is one of the largest Portuguese financial groups, with high domestic market shares in key areas such as customer deposits, loans and advances to customers, mortgages, insurance, mutual funds and real estate leasing. This strength of market position in Portugal provides CGD with a certain amount of inherent strength. Its credit standing, however, is constrained as the result of economic and financial weaknesses in Portugal.

Table 3: Country and Bank Credit ratings (S&P, long term debt, unless indicated otherwise)

Bank	Country rating (outlook) ¹	Bank rating (Outlook)
ANZ Banking Group Limited	Australia – AAA (stable)	AA- (stable) ²
Bank Mandiri	Indonesia - BB+ (positive)	Baa3 (stable) ³
GGD	Portugal – BB (negative)	B1 (negative) ⁴
BNCTL	Timor-Leste - Not rated	Not rated

Sources:

¹ Standard and Poors website <http://chartsbin.com/view/1177> (accessed 22 July 2015)

² http://www.rbnz.govt.nz/regulation_and_supervision/banks/prudential_requirements/credit_ratings/ (accessed 22 July 2014)

³ Moody's local and foreign currency deposit ratings, from https://www.moody.com/research/Moodys-concludes-review-on-three-Indonesian-banks-assigns-Counterparty-Risk--PR_326818 (accessed 22 July 2015). Note: A Baa3 Moody's rating is broadly equivalent to a BBB- S&P rating

⁴ Moody's long term debt rating 12 June 2015, as reported at <https://www.cgd.pt/english/investor-relations/credit-ratings/Pages/Ratings.aspx> (accessed 22 July 2015). Note that a B1 Moody's rating is broadly equivalent to a S&P B+ rating.

While Portugal's economic and financial situation has stabilized since entering into an IMF/EU/ECB supported adjustment program in 2011, as mentioned, it remains exposed to some on-going risks, including the risk of contagion from instability elsewhere in the euro area (as recently experienced in Greece). If, in the

unlikely event, that Portugal needed to apply exchange controls that restricted payments from being made abroad, access by the Timor-Leste branch of CGD to funds held abroad could become uncertain (even though CGD's own solvency was not in question).

Another possibility in situations where international banks encounter difficulties at home is that they shed non-core, and/or unprofitable, business operations abroad. That can be by way of either the sale, or run-off, of the overseas business. This underscores the need, in order to maintain overseas head office commitment, for the international banks in Timor-Leste to be successful in building a local business that contributes to their respective international group performance objectives.

CGD/BNU and Mandiri Bank have both grown their Timor-Leste balance sheets substantially since September 2013 – with total assets having increased by 88 per cent and 40 per cent, respectively. However, over the same period, the amount of these banks' loans outstanding has shrunk. Strong growth in customer deposits, instead, has funded investment in liquid assets, mainly abroad. ANZ's Timor-Leste balance sheet, by contrast, has grown by only 3 per cent, but its loan book has increased by 38 per cent (Appendix Table 1).

BNCTL

BNCTL is a Timor-Leste owned and incorporated bank. Unlike the three foreign banks, it has its own balance sheet in Timor-Leste.

In balance sheet terms, BNCTL is a smaller bank in Timor-Leste than the three foreign banks, but it has a large and predominantly Timorese customer base (Appendix Table 2). (By contrast, the customers in Timor-Leste of the foreign banks include, to a significant extent, interests associated with their respective home countries, i.e., Australia, Indonesia and Portugal.) The extent of BNCTL's local customer base makes it more systemically-important in Timor-Leste than its balance sheet size alone would indicate.

BNCTL has also grown strongly in the twenty one months to June 2015. Total assets have nearly doubled over that period. However, again, most of the growth has been in liquid assets, with deposit growth having substantially outstripped lending growth (Appendix Table 1).

As at 31 December 2014, BNCTL had ratios of capital to total assets, and of liquid assets to total assets, of 26% and 68% respectively. These are comfortable, if not high, ratios by most standards. Moreover, BNCTL's capital ratio, if anything, understates the adequacy of BNCTL's capital, given that its assets comprise predominantly low-risk liquid assets. On a risk-weighted basis, BNCTL reports a capital adequacy ratio at end 2014 of 56%.³ BNCTL's capital position was bolstered by a \$10m capital injection by its sole shareholder, the Government of Timor-Leste, during the year.

BNCTL's recent trading results have also been positive. While trading profit in 2014 (\$881,000) was 41 per cent down on the previous year, and further reduced by a significant (\$241,000) non-trading charge against income, losses on account of impaired loans remained comparatively low (\$127,000).

Overall, BNCTL retains a good financial (capital and liquidity) base from which to achieve further growth and development.

Branchless banking

All four of Timor-Leste's banks are in the process of developing or piloting branchless banking services. Different business models are being adopted by the different banks and are at different stages of development. They include various combinations of cash-in/cash-out facilities (using a portable device connected to the bank's computer system) and electronic (telephony-based) payment services.

A CGD/BNU facility, already being piloted, enables customers to withdraw cash (but not to deposit cash) at selected retail and telecom outlets. It also enables payments to be made using a mobile device, but only amongst CGD/BNU's own customers (other banks' customers have to join CGD/BNU's e-money system before they can receive payments). Mandiri Bank is at an earlier stage of developing a broadly similar system. And BNCTL is moving toward providing mobile cash-in/cash-out and customer account information services. Meanwhile, ANZ has plans to bring its *Go-Money* telephony-based facility, which already operates in a number of Pacific countries, to Timor-Leste. ANZ and BNCTL have also entered into a Memorandum

3 Source: BNCTL Audited financial statements for the year to 31 December 2014, signed by the directors and auditor 25 February 2014.

of Understanding to establish a shared 'Mobile Phone Banking Solution'. This has the potential to bring together the international, including technology, strengths of ANZ and the comparatively large local customer base of BNCTL.

These developments carry the potential substantially to extend the availability of banking services beyond Timor-Leste's main centres, and also represent significant first steps toward establishing greater inter-operability amongst Timor-Leste's banks, and toward the building of a 'financial system'. Hitherto, Timor-Leste's four banks have operated mostly in isolation from each other. It also marks a significant step, amongst others, toward building a modern payments system in Timor-Leste (discussed in the next chapter).

Micro-finance institutions

Two micro-finance institutions operate in Timor-Leste, Moris Rasik and Tuba Rai Metin (TRM). Although not licensed banks, both of these institutions have applied to be licensed under Public Instruction No 6/2010: On the Licensing and Supervision of Other Deposit-Taking Institution (ODTIs). This Instruction applies to institutions with total deposits of over \$500,000 but less than \$1 million.

These institutions play an important role in Timor-Leste, in providing sources of finance for micro-enterprises and deposit facilities for the hitherto unbanked. Taken together, these institutions have grown significantly in recent years, albeit one (Tuba Rai Metin) more than the other (Moris Rasik) (Table 4 and Appendix Table 3).

Table 4: Micro-finance Institutions

Year	Number of branches	Gross loan portfolio	Deposits
2011	11	1,801	2,721
2012	24	2,769	2,949
2013	24	3,691	3,567
2014	25	5,484	4,514
2015 (March)	NA	6,529	4,666

Credit unions

As noted in the Master Plan for Financial Sector Development in Timor-Leste, credit unions, based on the co-operative model, provide a potentially important channel for enabling the under-served to participate in the formal financial system. As at June 2015, they provide saving and credit services to members at 34 locations across Timor-Leste, with a further 54 candidates having been identified (Appendix Table 4).

Money Transfer Operators

Nine money transfer operators provide money transfer, including inward and outward remittance, services for the Timorese public, notably, again, for those who otherwise are 'unbanked' and therefore are not able to make and receive payments through the banking system. Recent data on remittances by MTOs are provided in Table 5.

Table 5: Remittances by MTOs

	Sept 2014		Dec 2014		Mar 2015		June 2015	
	In-ward	Out-ward	In-ward	Out-ward	In-ward	Out-ward	In-ward	Out-ward
Amount (\$000)	2,504	7,333	2,685	8,459	2,457	7,315	3,055	6,995
Number of	5,007	14,622	5,650	19,283	5,380	16,495	6,058	16,012
Average (\$)	510	502	477	439	457	443	504	437

Insurance

Currently, two insurance companies operate in Timor-Leste, National Insurance Timor-Leste (NITL) and Sinarmas Insurance (SMI). While the insurance market remains at an early stage of development, both companies have established a foothold. Following reported losses in the early years following commencement of operations in Timor-Leste, both companies reported profits for 2014-2015. Also, during 2014, the shareholders in both companies provided additional capital, signifying a commitment to further development of the insurance sector in Timor-Leste.

While these companies underwrite a range of risks, their main products are property

insurance, motor vehicle insurance and personal accident, health and travel cover. Claims to date have been low relative to premium income, but that may change as the insurance sector in Timor-Leste matures. Total claims settled by both companies in the six months to June 2015 totalled \$118.2 thousand, compared with net earned premiums of \$855.9 thousand.

A significant line of business for NITL is the underwriting of micro-insurance provided by the two micro-finance institutions, Moris Rasik and TRM. Under this arrangement, the micro-finance institutions are, in effect, acting as agents in delivering insurance services to the underserved.





4. Payments system development

There have been significant advances in the development of the payments system in Timor-Leste over the past year.

Two key developments have been as follows.

First, substantial progress has been made on the installation of Automatic Payment System, comprising a combination of a Real Time Gross Settlement System and an Automatic Clearinghouse System for clearing and settling payments within the banking system. The system is called Rede Transferénsia iha Momento Reál (or R-TiMOR). This system went live on 30 April 2015. It is a modern, automated, electronic system that links the banks in a way that enables interbank payments to move readily, efficiently, and securely from the payer to payee, across the respective banks' settlement accounts at BCTL.

R-TiMOR is operated by BCTL and is connected to all the banks and the Ministry of Finance by a highly secure private interbank data network. Each of the system participants (including BCTL) will use R-TiMOR to send instructions to make payments to other participants. The system can handle any kind of payment for any amount, whether large or small. Payments are carried out by R-TiMOR which transfers funds between the accounts of the participants which are held within the system. Because these transfers are made at electronic speed, bank customers will receive funds in their accounts very quickly and normally on the same day the payment is sent. BCTL expects that within a short time a very great percentage of payments will be made electronically via R-TiMOR, particularly

Government payments such as salaries and welfare payments.

Installation of this system provides a good foundation from which further development of electronic means of payment in Timor-Leste will be possible. Those further developments include electronic-funds-transfer-at-point-of-sale (EFTPOS) and credit card facilities that operate automatically amongst the banks on a multilateral basis, i.e., that enable those with a card issued by one bank to make payments to people and firms that bank with other banks. The current lack of this multilateral functionality has stifled the development of card-based payments in Timor-Leste.

Second, the Decree-Law on National Payments System was promulgated by the President of the Republic on 18 June 2015 and published in the Official Gazette on 25 June 2015. This decree-law legitimizes and clarifies the obligation of the Central Bank of Timor-Leste (BCTL) to establish, regulate and supervise the National Payment System (SNP) as a whole, with the objectives of promoting its efficiency and security, as well as limiting the risks, in particular systemic risks, and of promoting transparency and the protection of clients. It also defines the competences and powers of BCTL to regulate and supervise the SNP, while at the same time establishing a system for authorization of providers of payment services. Additionally, it regulates the settlement, clearing and definitive character of payments, as well as electronic payments and electronic currency.

Third, there have been significant steps in the development of cell-phone based banking in Timor-Leste. Timor-Leste is well-placed for delivery of banking services via this medium given the level of penetration of cell phones in the country. (There are at least as many cell phones in Timor-Leste as people, although a significant proportion of those devices will be inactive and some people will have multiple devices.)

Table 7: Penetration of Telecommunication operators (March 2015)

Providers	Total Client	Agents
Timor Telecom	661,797	13
Telemor	580,000	13
Telkomcel	132,000	13
Total	1,373,797	39

Source: General Directorate of Statistics

As noted above, all four banks in Timor-Leste are either developing or piloting branchless banking arrangements. These, to varying degrees, incorporate electronic payments functionality.

While future development, and uptake, of telephony-based banking services can be expected to result in correspondingly less use of cash as a means of payment, it may be some time before these technologies achieve wide penetration. For the meantime, therefore, BCTL continues to see a need also for agency arrangements, under which agents can conduct cash-in/cash-out transactions on behalf of banks where they do not have a branch (or an ATM) presence. The steps being taken to

develop these kinds of arrangement, therefore, are also welcome.

Finally, BCTL is working on the establishment of a National Card and Mobile Switch. The Strategy for the development of the National Payment System sets out the objectives for implementing a National Card and Mobile Switch as follows:

BCTL will encourage the widest possible usage of payment services based on the use of both cards (debit and credit) and mobile phones as the means of access to the payments system. This includes the requirement, as noted above, that all such services are fully interoperable. In the longer term BCTL may also consider the entry into the retail payments market of non-bank institutions, subject to their being approved and licensed by BCTL.

In order to achieve inter-operability of all card- and mobile phone-based payment circuits, in the near to medium term BCTL will encourage the commercial banks to establish a common, nation-wide electronic network and switch which will: (i) interconnect the ATM, EFTPOS and mobile payment circuits of all banks and ODTIs, and (ii) include a common clearing and netting capability for all transactions, with automated forwarding of net inter-participant positions to the RTGS element of the ATS for settlement.

The concept of the future network, centered on a National Card and Mobile Switch (NCMS), envisages that customers of any bank will be able to use the ATMs, Point of Sale (POS) and mobile networks of any other bank to make payment transactions.



5. Financial Inclusion Initiatives

A major program aimed at lifting financial literacy amongst the underserved was commenced in late 2014. Public roll-out of the National Program on Financial Education commenced on 29 November 2014 with a first National Savings Day, launched by the President H.E. Mr Taur Matan Ruak.

The main objectives of the program are to raise awareness about personal and small business finances so as to inculcate the habit of saving, and to enable advantage to be taken of financial opportunities, including by using saving, insurance and improved financial knowledge to manage risk.

There are three important themes:

- Plan – for financial independence. To achieve this, people need to get into the habit of planning for their future and think beyond the current practice of living day-to-day. Banks can help people throughout the community with financial planning.
- Save – there is an urgent need for people to think about saving as well as spending more wisely. Banks can play an important role in helping people to save.
- Protect – the campaign will emphasize how by protecting wealth – farms, crops, houses, motor vehicles, as well as children, jobs and health – wealth can accumulate over time to the benefit of individuals and the community.

The program is broad-based, covering, as target groups, students, veterans, and small-medium size enterprises, including in the districts. The

main delivery mechanism is through building a cadre of trainers, amongst the commercial banks and others, who can deliver training in financial management to target audiences.

By the end of June, this program has reached 11 Municipals and about 3,850 people from various target audiences such as students, parents of students, civil servants, micro credits, cooperatives, women and youth groups.

In November 2014, BCTL also commenced engagement with key stakeholders on a National Strategic Plan (NSP) for Financial Literacy. A consultative meeting was held in March 2015, and the official launch of a resulting Strategic Plan is anticipated to occur shortly. This National Strategic Plan for Financial Literacy provides a roadmap to improve the level of financial literacy in the population and to improve the ability of people to manage their personal financial affairs. It is a strategic document that establishes a five year plan for the period 2016-2020. There are five focus areas: building the capacity and capability of the sector, providing leadership, reaching the target audience, maintaining the quality of financial advice and sharing what works.

The BCTL has also worked with all commercial bank to introduce a children's savings account program called "Ha'u-nia Futuru". The objective of the "Ha'u-nia Futuru" program is to encourage children to discover the benefits of saving money by having an account at a bank and watching their deposit grow as further contributions and interest increase the balance.

The target for the program is all Timorese children from birth up to 17 years old. All benefits will accrue to the account holder because no fees or charges will be applicable to these accounts and the accounts will earn interest at an above-market rate. No withdrawals or payments from an account can be made until the holder's 17th birthday.

BCTL has also worked with the ADB and the University of New South Wales (UNSW) on a branchless banking agent networks project. A resulting Circular Letter 14/2015: Guidelines on the Use of Agents in Branchless Banking (hereafter, the Circular Letter) was introduced on 20 February 2015. The Circular Letter sets out a regulatory framework for the use of bank agents in the delivery of branchless banking in Timor-Leste. Those guidelines include the duty of reporting to the central bank, the responsibilities of the banks with respect to the behavior of their agents, rules on the selection and monitoring of agents, as well as general compliance rules on customer identification and protection and money laundering.

These guidelines have been followed up with other initiatives. In April 2015, training was provided to all compliance officers of commercial banks. The objective of this training was to enhance the understanding of the commercial banks about the requirements applicable to banks engaging agents in branchless banking. And in May 2015, a BCTL team mapped possible agents in Dili, to identify some shops or workshops that are potential agents for banks, and for whom introductory training will be organized by BCTL. This activity has listed 35 shops or workshops.

In July 2015, BCTL, ADB and the UNSW team produced a policy paper on supervision and protection of float in branchless banking. The general objectives of this paper were to:

- describe in theory how different branchless banking models operate, and to highlight the various considerations with respect to protecting the e-money float in branchless

banking.

- describe the legislative and regulatory framework for branchless banking activities in Timor-Leste – as it currently exists and is being developed – specifically, as it relates to the e-money float.
- describe the branchless models currently being used, or considered, by the four banks in Timor-Leste, to illustrate how, or whether, an e-money float exists in these models.
- outline policy considerations for protecting the float, taking into consideration that at this time only bank-led branchless banking models are permissible in Timor-Leste.

In mid-August 2015, the BCTL, ADB and the UNSW team also produced a policy paper on consumer protection in branchless banking. The general objectives of this paper were to:

- underscore the importance of the consumer protection framework for branchless banking activities as it is integral to the broader success of financial inclusion strategies.
- identify consumer protection issues which arise in branchless banking and the resulting key principles to incorporate into financial consumer protection frameworks for branchless banking activities.
- assess existing financial consumer protection arrangements for branchless banking activities in Timor-Leste and consider the broader financial consumer protection arrangements in Timor Leste.
- make recommendations on the further development of consumer protection policies for branchless banking in Timor Leste.

These initiatives build on recent indicators of progress in extending the availability of financial services to the people of Timor-Leste. Since mid-2013, the number of bank branches has increased by 30 per cent (from 24 to 31), and the number of ATMs has doubled (from 20 to 40) (Appendix Table 2). During the same period, bank deposit account numbers have increased by 36 percent and the balances in

those accounts by 49 percent. Deposit balances at micro-finance institutions have increased by a similar percentage (Appendix Tables 1 and 3).

So far, however, this progress has been focused more on Timor-Leste's urban centers than on the outlying districts. BCTL wishes to achieve increased financial inclusion more broadly and, with this goal in mind, is encouraging the development of branchless banking in Timor-Leste. This includes, as outlined in chapter 3, through the development of telephony-based banking and payment services, and provision of 'cash-in, cash-out' services by agents acting for the banks. BCTL is working with the banks on the implementation of the protocols set out in the Guidelines on the use of Branchless Banking issued in February 2015 (elaborated above).

Also, less progress has been made, so far, on extending the availability of credit to Timorese

firms and households (Figures 1 and 2). Whereas the number of deposit accounts with banks has increased by nearly 95,000 since June 2013, the number of loan accounts over the same period has increased by less than 2,000.

These trends are reflected in figure 2 in declining loan to deposit ratios, particularly for banks, where deposit growth has outstripped lending growth by a sizeable margin. (Loan to deposit ratios for micro finance institutions are considerably higher, owing to those institutions raising only a small proportion of their funding from deposits; the majority of these institutions' funding is raised from donor sources and by borrowing.) Accordingly, a major policy priority for the period ahead is to strengthen the policy settings for enabling Timorese firms and households to borrow and financial institutions to lend.

Figure 1: Number of bank accounts in Timor-Leste

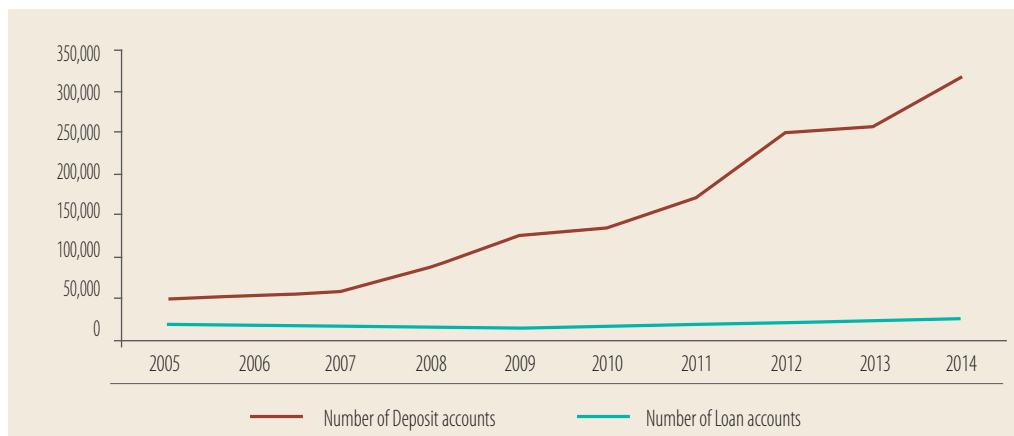
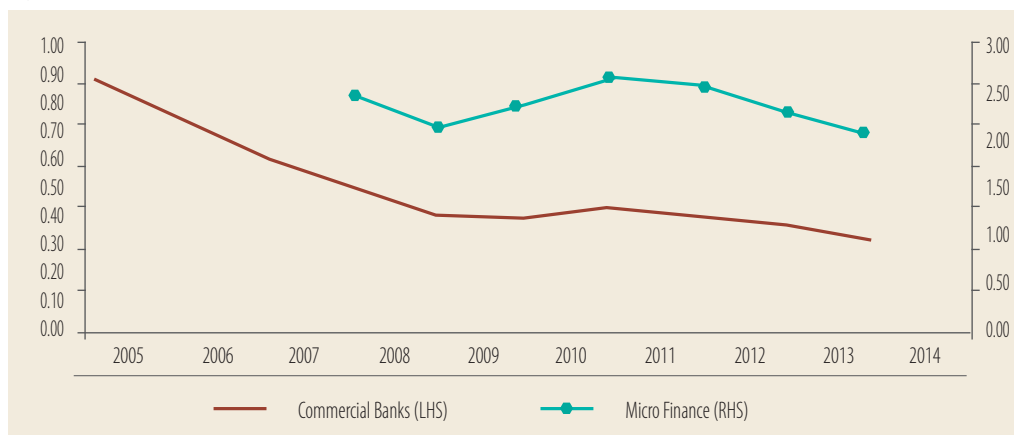


Figure 2: Loan to deposit ratios, commercial bank and micro-finance institutions





6. Other policy and infrastructure developments

Collateral to enable borrowing and lending

As noted above, a major impediment to borrowing and lending in Timor-Leste is the lack of means by which borrowers can offer collateral in support of applications for credit. This results in little lending taking place other than to borrowers with a cash-flow that the lender can rely on, such as, for example, a salary that is credited directly to the lending bank. Raising funds for business development is less easy, although, in the micro-lending market, group guarantees, which result in peer pressure on borrowers to repay, have proven to be an effective alternative to collateral.

The Master Plan for Financial Sector Development in Timor-Leste proposes early attention be given to better establishing effective arrangements for enabling moveable property (e.g., motor vehicles, plant and equipment, inventories and trade debtors) to be offered as collateral; with immovable property (land and buildings) similarly to be capable of being used as collateral once land titles have been clarified.

Consistent with this approach, a discussion paper on secured loan transaction reform was issued in October 2014. Following consultation, the necessary legislation currently is being prepared, with a first draft currently expected to be shared for consultation by end 2015. After the new law has been enacted, there will be a need for procurement and the launch of

an online collateral registry, and engagement with banks on the development of new lending products that will make use of the new registry.

Development Bank

Initial steps are being taken this year, now under the leadership of the Ministry of Finance (previously SEAPRI), to establish a National Development Bank for Timor-Leste. In June an outline of the role and broad structure of the Bank was presented to the Council of Ministers for its consideration. Leading up to the presentation, SEAPRI analyzed all options and assessed the strengths and weakness of different models. It is well-recognized that not all international experiences with development banks have been positive. Key lessons are being taken on board in the current deliberations including the importance of solid corporate governance, dispersed ownership, co-financing and the need for a clear choice on which sectors to support. It is also a proviso of the Government that the National Development Bank must be run in a way that supports market competition in the financial sector and encourages, rather than inhibits, the growth of private banking.

Banking law and consumer protection

BCTL has commenced a comprehensive review of Timor-Leste's banking law (Regulation No. 2000/8 on Bank Licensing and Supervision). This law dates from the early stage of UN Administration of Timor-Leste. It is time to review and update that law to provide a modern

foundation for the development of banking in the decade ahead.

The Master Plan also provides for BCTL to engage with financial institutions regarding principles of client protection to apply in their dealings with 'retail' customers. Existing regulations (Public Instruction 06/2010 and clause 2.5 of Regulation 2000/8) already set some basic requirements. But in recent years, globally, there has been increased recognition of the need for financial institutions to go beyond mere compliance with minimum standards. Today's expectation is that financial institutions play a more positive role in taking account of the interests of their customers.

In the light of the progress outlined above on developing branchless banking facilities in Timor-Leste, and the importance of that for achieving greater financial inclusion, particular attention is being given to providing a foundation for public confidence in branchless banking services. To this end, Timor-Leste has adopted a bank-based model for mobile banking. Consistent with this approach, e-money issued by banks should be regarded as a bank deposit, and as coming fully within the ambit of banking regulation. BCTL in February 2015 issued a circular letter to banks in Timor-Leste providing guidelines on the use of agents in branchless banking. These address the arrangements that must be in place to provide a basis for the public to transact with confidence with banks' agents. Those include requirements in relation to systems and audit

trail, agent identity, agent selection, bank responsibility for its agents, transparency and a customer complaints process.

Local incorporation of international banks

Three of Timor-Leste's four banks are branches of international banks. The Master Plan raises the question whether, for these banks, the branch structure represents a suitable arrangement, or whether it would be preferable for these banks' operations in Timor-Leste to be conducted through a locally incorporated subsidiary company.

The advantage of being locally incorporated is that the overseas assets of the international bank in Timor-Leste, legally, would be more clearly owned by the bank in Timor-Leste. This could help to insulate Timor-Leste from an international banking crisis that involved an international bank with a presence in Timor-Leste. The possible disadvantage is that it could weaken the backing by the international bank for its operations in Timor-Leste.

BCTL has decided to commence examination of this matter. It involves some complex issues and warrants early consideration given the experience in recent years of banking instabilities having been transmitted across international borders. If it is concluded that a change in structure is called for, transition arrangements are envisaged that would provide time for existing branch banks to adjust.



Data Appendix

Appendix Table 1: Commercial banks – financial overview

	ANZ			CGD			Mandiri			BNCTL			Total		
	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Total Timor-Leste assets	68	148	132	121	196	292	136	273	267	13	48	74	338	665	765
Loans in Timor-Leste	5	44	69	84	100	83	14	11	4	7	21	33	110	176	189
Non-performing loans	--	--	--	--	--	--	--	--	--	--	--	--	-46.3	-49.5	-46.5
Deposits in Timor-Leste	67	128	119	112	144	219	116	202	184	7	31	48	302	505	570
Loan/deposit ratio	7.5%	34.4%	58.0%	75.0%	69.4%	37.9%	12.1%	5.4%	2.2%	100.0%	67.7%	68.8%	36.4%	34.9%	33.2%

Appendix Table 2: Other banking system indicators

	ANZ			CGD			Mandiri			BNCTL			Total		
	Dec-10	Dec-13	June-15	Dec-10	Dec-13	June-15	Dec-10	Dec-13	June-15	Dec-10	Dec-13	June-15	Dec-10	Dec-13	June-15
Points of presence in Timor-Leste															
- Branches	1	2	2	8	9	13	1	1	2	1	13	14	11	25	31
- ATM	8	6	7	6	11	27	5	5	10	0	0	0	19	22	44
- Staff	44	56	40	73	97	118	42	52	51	144	221	256	303	426	465
Number of Account (deposit and Loans)	14,694	14,842	13,802	51,597	65,339	61,299	39,922	46,013	47,314	46,573	156,730	247,771	152,786	282,924	370,186

Data Appendix

Appendix Table 3: Micro finance institutions and financial cooperatives

	Moris Rasik			TRM			Total Micro-finance institutions			Financial Cooperatives	
	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15	Dec-10	Dec-13	Jun-15	Sep-13	Jun-15
Number of Depositors	10,795	10,204	9,510	2,735	3,313	6,564	13,530	13,517	16,074	6,547	NA
Number of Borrowers	10,719	8,042	6,962	38,862	8,096	8,441	49,581	16,138	15,403	NA	NA
Staff (number of)	124	152	149	83	117	166	207	269	315	NA	NA
Number of branch	13	13	13	6	11	15	19	24	28		
Loan assets (US\$ 000)	4,367	4,153	4,048	869	3,691	7,910	5,236	7,844	11,958	1,162	NA
Other assets (US\$ 000)	3,379	2,779	2,700	30	30	128	3,409	2,809	2,828		
Total assets (US\$ 000)	7,392	6,643	6,524	1,424	4,654	9,488	8,816	11,297	16,012	NA	NA
Borrowings (US\$ 000)	2,785	745	183	375	2,061	4,593	3,160	2,806	4,776	NA	NA
Deposits (US\$ 000)	1,992	2,344	2,771	219	1,197	2,285	2,211	3,541	5,056	NA	NA
Members' subscriptions	NA			NA			NA			1,109	NA
Capital (US\$ 000)	2,409	2,829	2,705	730	1,261	2,501	3,139	4,090	5,206	1,293	NA
Other liabilities (US\$ 000)	207	726	865	99	134	110	306	860	975	NA	NA
Total liabilities & Capital (US\$ 000)	7,392	6,643	6,524	1,424	4,652	9,488	8,816	11,295	16,012	NA	NA

Appendix Table 4: Points of access to financial services – by municipal area (June 2015)

Municipals	Population	Banks			Micro-finance	Credit Union		MTO	Insurance
		Bank & Branch	ATM	EFTPOS		Active	Candidate		
Aileu	59,179	2	1		2	0	1		
Ainaro	44,325	2	-		2	1	7		
Baucau	111,694	2	1		2	5	4		
Bobonaro	92,049	2	1		2	2	2		
Covalima	59,455	2	-		2	0	3		
Dili	234,026	8	37	107	2	10	5	9	2
Ermera	117,064	2	-		2	2	3		
Lautem	59,787	2	1		2	3	2		
Liquica	63,403	2	1		2	0	16		
Manatuto	42,742	2	1		2	4	4		
Manufahi	48,628	2	-		2	0	5		
Oecusse	64,025	3	1		2	3	1		
Viqueque	70,036	2	-		2	4	1		
Total	1,066,409	33	44		26	34	54		



Glossary

ADB	– Asian Development Bank
ANZ	– Australia and New Zealand Banking Group Limited
ATM	– Automatic Teller Machine
ATS	– Automatic Transfer System
AUD	– Australian dollar
BCTL	– Banco Central Timor-Leste
BNCTL	– Banco Nacional De Comercio De Timor-Leste
CGD	– Caixa Geral de Depósitos S.A (the Portuguese bank)
CGD/BNU	– BNU Timor - Grupo Caixa Geral de Depósitos
CPI	– Consumers' Price Index
ECB	– European Central Bank
EFTPOS	– Electronic Funds Transfer at Point of Sale
EU	– European Union
FCCHM	– Federação Cooperativa Crédito Hanai Malu (the Federation of Financial Cooperatives)
GDP	– Gross Domestic Product
IDR	– Indonesian Rupiah
IMF	– International Monetary Fund
MTO	– Money Transfer Operator
NCMS	– National Card and Mobile Switch
NITL	– National Insurance Timor-Leste
NSP	– National Strategy Plan (for financial literacy)
ODTI	– Other deposit-taking institution
RTGS	– Real Time Gross Settlement
SEAPRI	– State Secretary for the Support and Promotion of the Private Sector
SMI	– Sinarmas Insurance, SA
TRM	– Tuba Rai Metin
USD	– United States dollar