Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 11-Dec-2023 | Report No: PID302

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Operation ID	Operation Name	
Fiji, Kiribati, Marshall Islands, Micronesia, Federated States of, Nauru, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu	P502591	Pacific Finance for Growth Project	
Region	**Estimated Appraisal Date**	**Estimated Approval Date**	**Practice Area (Lead)**
EAST ASIA AND PACIFIC	17-Apr-2024	16-Jul-2024	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing (IPF)	Ministry of Finance of Kiribati, Ministry of Finance of Fiji, Ministry of Finance of Samoa, Ministry of Finance of the Federated States of Micronesia, Ministry of Finance of Nauru, Ministry of Finance of Solomon Islands, Ministry of Finance of Marshall Islands, Ministry of Finance of Tonga, Ministry of Finance of Vanuato, Ministry of Finance of Tuvalu	Pacific Islands Forum Secretariat (PIFS)	

Proposed Development Objective(s)

The PDO is to strengthen the economic and financial resilience of Pacific Island countries facing the withdrawal of their correspondent banking relationships.

PROJECT FINANCING DATA (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Operation Cost	**120.00**
Total Financing	**120.00**
of which IBRD/IDA	**120.00**
Financing Gap	**0.00**

DETAILS

World Bank Group Financing

International Development Association (IDA)	120.00
IDA Credit	30.00
IDA Grant	90.00

Environmental and Social Risk Classification	Concept Review Decision
Low	The review did authorize the preparation to continue

B. Introduction and Context

Country Context

The Pacific Island Countries (PICs) covered by this operation (Fiji, Kiribati, Palau, Nauru, Vanuatu, Marshall Islands, Solomon Islands, Samoa, Tonga, Tuvalu, and Micronesia) are characterized by their small size, remoteness, geographic dispersion, and high degree of exposure to economic shocks, climate change, and natural disasters. Owing to their economic geography, growth in some PICs lags peers. Although extreme poverty is uncommon, poverty and hardship exist, and access to cash incomes, basic infrastructure, social services, and nutritious food is uneven. Because the population is dispersed, often across archipelagos, the costs of public administration and service delivery are high, limiting the quantity and quality of services available. Migration to the United States, New Zealand, and Australia has mitigated unemployment, and remittances have contributed to elevated living standards and served as a source of foreign exchange.

Sectoral and Institutional Context

While stable, financial systems in PICs have been characterized by a limited range of financial products coupled with low levels of access. Despite high levels of capital and liquidity, and a general recovery in profitability and credit to the private sector, the banking sector in PICs is characterized by high rates of non-performing loans. The scope of financial products and services is limited, encompassing deposit-taking, unsecured personal loans, mortgage-based lending, trade finance, and payment facilities. In several PICs, much of the population lacks access to bank accounts, which limits individuals' ability to save, invest, or hedge against shocks.

PICs are vulnerable to withdrawal of correspondent banking relationships (CBRs) by international banks. CBRs underpin the global payment system enabling cross-border transactions.[1] Over the past decade, cross-border correspondent bank relationships have declined 30 percent globally and 60 percent in the Pacific.[2] The withdrawal of CBRs has adverse consequences, impeding access to cost-effective financial services needed for trade, investment, remittances, and commercial transactions. This is critical for Pacific Islanders, including seasonal laborers, SMEs, and vulnerable populations. CBRs underpin international trade, remittances, and humanitarian financial flows among countries and are needed to support economic growth and development.

The withdrawal of CBR services would remove access to the global financial system for PICs. Beyond disrupting essential payments and transactions needed for remittances and trade flows, the impact extends to processing of development, humanitarian, and disaster relief funds. The withdrawal of CBRs could also drive financial activity out of the regulated financial system into informal channels, posing risks and challenges for financial oversight. This may result in higher expenses for financial services that are already costly, impeding efforts to promote financial inclusion and the digitization of commercial transactions. Key sectors such as tourism, trade, and extractives would be adversely affected. Remittance flows, which are equivalent to 50 percent of GDP in some countries, would become more expensive, impacting seasonal laborers and vulnerable populations, especially women.

Responding to a request from the Pacific Island Forum (PIF), the World Bank in 2023 undertook a comprehensive diagnostic to assess the current state of CBRs and proposed mitigation measures. This focused on a sub-set of PIF member countries and assessed existing CBR conditions, remedial actions taken, and lessons learned. The diagnostic provided eight recommendations to prevent further CBR withdrawals, which the PIF Economic Ministers Meeting endorsed in August 2023. The corresponding CBR Action Plan, which builds on the eight recommendations and provides a series of prioritized and sequences measures. The Bank also recommended the establishment of a Pacific De-risking Group aimed at facilitating implementation of proposed actions, aligning with regional initiatives.

While there is limited transparency and data on CBRs, the Bank's analysis in the CBR report indicates the Pacific region has experienced a significant withdrawal recently, albeit to varying degrees with some countries having no or limited access to major currency channels (e.g., US dollar, Euro, and Australian dollar). There are two drivers of this phenomenon, which is known as "de-risking." Rising risk management and compliance costs in relation to anti-money laundering and countering the financing of terrorism (AML/CFT) contributed to a worldwide contraction in the corresponding banking networks. Second, and perhaps more importantly, the small scale of PIC provides limited profit and business opportunities for international banks to provide CBR services, which does not outweigh the risks of fines and reputational damage for breaches of international financial integrity standards.

The urgency and capacity to address CBR withdrawal varies across PICs. Fiji, Palau, and the Cook Islands report no problems. Tuvalu, Marshall Islands and Kiribati have few CBRs left and are vulnerable. Nauru recently lost its only banking service, which will leave it without CBRs by December 2024 unless it can find a new provider. The only international bank in Marshall Islands has stated its intention to leave. The challenges are more pronounced for USD and EUR accounts. Some countries have limited capacity to maintain CBRs as AML/CFT compliance may not be sufficient to incentivize correspondent banks to provide services.

[1] According to the Committee on Payments and Market Infrastructures (CPMI), most cross-border transactions are undertaken via the correspondent banking model or the single platform model (closed-loop solutions). Other models (e.g., payment system interlinking, multilateral payment platforms, payment aggregators), which play a comparatively small role in the cross-border market, may complement, or help reduce dependency on correspondent banking. For instance, interlinking of fast payment systems is gaining traction in East Asia and globally.

[2] World Bank, The Decline of Correspondent Banking in Pacific Island Countries, 2023.

Preventing CBR withdrawal is critical and requires close collaboration between home, primarily the US and EU, and host jurisdictions in PIC. Once international banks terminate CBRs, reinstating them is hard. While better national compliance with AML/CFT standards and international tax requirements is necessary, it is not necessarily sufficient to prevent banks from limiting or ending CBR services. Addressing issues related to the volume of transactions and profitability of offering CBR services to PICs is essential. This is the primary cause of CBR withdrawal. Addressing this requires regional strategies to aggregate payment flows, share regulatory and supervisory capacities between PICs, shorten cross-border transaction chains, and efforts to reduce due diligence and other compliance costs.

There is greater international recognition of the challenge and the need to provide bilateral and multilateral support to PICs facing withdrawal of their CBRs. Given that most problems occur with USD, active involvement of the US as a home jurisdiction is a precondition. In March 2023, the US Treasury Department published its De-risking Strategy, indicating it will be exploring regional approaches to aggregate payment flows. Bilateral efforts include the Pacific Banking Forum[3] announced by the United States and Australia in October 2023.

Remittances to PICs are a critical social safety net but remain above global cost targets and average costs. The global average cost for sending remittances was 6.2 percent relative to an EAP average of 5.9 percent, which are both higher than the UN and G20 target of 3 percent by 2030. Even with the introduction of new services,[4] migrant workers in Australia pay 12.3 percent, 8.2 percent, and 8.1 percent to send money to Vanuatu, Samoa, and Tonga, respectively.[5] This is consistent with a persistent gap between the global average cost of remitting and the average cost of remitting to small states shown in World Bank data. Among other factors, scale, competition (or lack thereof) and de-risking increase the cost. The governments of Australia and New Zealand, with assistance from the World Bank, ADB, IMF and UNCDF have supported initiatives to reduce remittance costs in the Pacific.

Relationship to CPF

The proposed operation is consistent with the World Bank Group's draft Regional Partnerships Framework (RPF) and comes at the explicit request of PICs. It also supports pillars of the FY22 RPF associated with protecting incomes and livelihoods and strengthening the enablers of growth and opportunities. The planned interventions are aligned with respective country partnership frameworks, including on ensuring macroeconomic stability and fostering private sector growth. It considers the lessons learned from the 2020 Performance and Learning Review, particularly the need for reduced fragmentation and stronger collaboration with regional organizations.

The operation supports a key G20 priority on enhancing cross-border payments, which are typically slow, expensive, opaque, and less accessible than domestic payments. The Financial Stability Board, in coordination with the Committee on Payments and Market Infrastructures (CPMI), the IMF, the World Bank and standard-setting bodies, developed a Roadmap to improve cross-border payments, which G20 Leaders endorsed in November 2020. This initiative established quantitative targets for addressing the cross-border payment challenges. Under the G20 Roadmap, the IMF and World Bank are tasked with providing cross-border payments TA (action 14).6

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[3] The Pacific Banking Forum's aims to address CBR withdrawal, enhance collaboration between public and private sectors, and mobilize technical support. The forum also seeks to improve CBR cost and accessibility, considering jurisdiction-specific challenges and exploring regional approaches.

[4] The 'Ave Pa'anga Pau (APP) product was launched by Tonga Development Bank (TDB) with support from the World Bank and IFC in New Zealand and Australia. It allows clients to purchase a voucher in AUD or NZD and makes the equivalent amount available in Tonga. No physical money crosses borders, and TDB avoids FX risk. Sending USD 200 to Tonga with APP costs less than 4 percent relative a PIC average of 9 percent.

[5] World Bank. Remittance Prices Worldwide Database.

[6] CPMI is leading an effort to develop governance and oversight of cross-border payment system interlinking arrangements, of fast payment systems, as a priority in helping to achieve the G20 Roadmap targets for the cost, speed, access, and transparency.

The proposed operation is aligned with the Nationally Determined Contributions (NDCs) submitted by the Pacific Island Countries (PICs). Across target sectors, the NDCs of PICs universally emphasize electricity generation, with additional common threads focusing on the renewable sources of electricity and advancements in the transport sector. Primary sectors prioritized for adaptation efforts encompass water and agriculture, while the most vulnerable sectors include water, natural disasters, health, ecosystems (coast/land), and agriculture. The planned operation does not hinder progress in these target and adaptation priority sectors. In terms of costing, all NDCs incorporate components conditional upon external resources. Through its activities, such as the digitization of financial services and enhancements in cross-border payment systems, the operation facilitates the mobilization of external financial resources, addressing the financing gaps essential for realizing the NDC goals set forth by the PICs.

C. Proposed Development Objective(s)

The PDO is to strengthen the economic and financial resilience of Pacific Island countries facing the withdrawal of their correspondent banking relationships. This will involve supporting PICs to (i) establish a regional facility for CBR services that provides a single point of entry for correspondent banks, (ii) promote financial access and interconnectivity through investments in financial infrastructure, and (iii) enhance regional resilience through policy and regulatory reforms, risk assessments, upstream work.

Key Results (From PCN)

PDO and intermediate level indicators could include:

- *Correspondent Banking Relationships*: financial resources available for a regional facility and indicators on provision of CBR services and institutional capacity of the regional facility that will be established.
- *Cross-Border Payment Efficiency*:
  - Speed [e.g., (a) percentage of cross-border wholesale payments (other than forward-dated) credited within one hour/within one business day of payment initiation; (b) percentage of cross-border retail payments services that credit recipients within one hour/one business day of initiation; (c) percentage of services making remittance funds available to the recipient within one hour/within one business day.
  - Cost [e.g., (a) average cost of retail (non-remittances) cross-border payment transactions; (b) average cost of sending USD 200 remittance].
- *Financial Inclusion*: Percentage of Pacific islanders with access to basic financial services, such as transaction accounts, loans, and utilization of digital payments options.

D. Concept Description

The project seeks to address structural challenges, exogenous shocks, and market failures that prevent Pacific Island firms and individuals from transacting in foreign currency and across borders. It will help to resolve long-standing issues and increase the resilience of PICs to financial de-risking by focusing on three key activities: (1) provision of CBR services through a regional facility; (2) promoting financial intermediation through investments in financial infrastructure; and (3) enhancing the foundations of regional resilience through support on policy and regulatory reforms, risk assessments, and building the capacity of PICs to manage regional initiatives.

Component 1: Provision of CBR services. In the first phase, the project would support a sub-set of PICs to establish a regional facility to provide contingent financing in the case of complete withdrawal of CBR in one or more currencies. To ensure equitable participation, quotas for each country will be established based on their financial needs and capital contributions. Guarantees may be needed, either for the entire facility or transaction-by-transaction, to satisfy regulatory requirements for CBR services in home jurisdictions (e.g., US, UK, EU). Initially, the regional facility would identify and contract a third party to provide CBR services thereby serving as safety net for PICs facing the withdrawal of their last CBRs. In a subsequent phase, the mandate would evolve towards taking on the functions of a respondent bank that would serve as a single point of entry for correspondent banks operating in PICs classified as high-risk of CBR withdrawal. It would have the following characteristics:

- The regional facility could be established through capital contributions, financed by this operation, from a sub-set of PICs ready to support a regional solution to de-risking and provided with a guarantee to lower the counterparty risk. The regional entity would provide a standardized set of services that additional PICs could benefit from by contributing capital as they become ready. Providing it with a guarantee would lower the counterparty risk of the facility and could be necessary to facilitate correspondent banking transactions. The structure of the guarantee, including whether it would cover the entire facility or be transaction-by-transaction, will be assessed during subsequent stages of project preparation. As part of its mandate, it would also be responsible for monitoring regional compliance with international standards, tracking CBRs per jurisdiction, and maintaining a common CBR Resilience Index developed based on a standardized regional reporting template. The CBR Resilience Index would provide an early warning mechanism for PICs at high risk. Moral hazard would be mitigated by making access to the financing contingent on continued progress with implementing international financial integrity and tax cooperation measures.
- The regional facility will be financial sustainability with an effective multilateral governance framework. It will have sound governance including an executive committee. Its capital will be invested in low-risk instruments to generate positive returns. It will charge a fee to PICs utilizing its services, further contributing to its financial sustainability. This approach ensures that the facility not only functions as a safety net for PICs but also operates as a financially viable entity. The investment policy and other operational documents prepared by the facility will be subject to the Bank's non-objection.

Component 2: Promoting regional financial connectivity and intermediation. The operation aims to support regional integration of payment systems and other financial infrastructures to enable cross-border transactions for market participants and their clients. It will leverage efforts to develop national ID systems supported by the Pacific Infrastructure Connectivity, Sustainability and Resilience (PICSAR, P502852). This integration would further enhance the efficiency and effectiveness of financial transactions while contributing to broader initiatives aimed at bolstering regional connectivity and technological advancements. Support will take different forms including collaboration, interoperability, harmonization, and integrated technical platforms. Key activities include:

- Support for the analysis and development of a regional multilateral payment platform (MLP) to shorten transaction chains and reduce reliance on USD/bridge currencies in cross-border payments between PICs. The regional platform would provide multicurrency support to cater to economies within the group. It can also serve as a regional hub and link between the region and its main trading partners by (i) facilitating easier and more cost-effective transactions for foreign financial institutions and other entities with banks and payment service providers and (ii) interlinking with other domestic and regional infrastructures. It can support AML/CFT compliance through pre-payment checks, transaction screening and monitoring as well as onboarding and participant compliance programs. The MLP will support a wide range of use cases – from interbank payments to commerce payments and consumer remittances. Aspects related to governance, business case and viability, and oversight will be evaluated, and alternative models considered/compared.

- The operation will support investments in financial infrastructure to increase PIC's preparedness to join multilateral initiatives to address regional cross-border payment challenges. For instance, the Bank for International Settlement's Innovation Hub (BISIH) is working with central banks in the Association of Southeast Asian Nations (ASEAN) to connect their national payment systems through a cross-border payment gateway and payment scheme known as "Project Nexus." As PICs modernize their domestic payments infrastructure, frameworks such as Nexus can provide a cost-effective solution to achieve regional and global connectivity. Other innovative cross-border payment solutions (e.g., digital currencies) could also be leveraged through this channel. Integrating PICs in these frameworks would be strategic.
- The operation will support the harmonization of legal, regulatory, and technical standards across PICs, as pre-conditions for interlinking and multilateral platforms. This could involve supporting efforts by participating countries to harmonize legal and regulatory regimes, aligning licensing requirements, and developing cooperative oversight arrangements for PSPs operating in multiple PI jurisdictions. Particularly the emergence of fintechs in the cross-border market challenges the effectiveness of existing regulatory and supervision frameworks with a domestic reach. A coordinated sandbox-like approach amongst PICs can help lower barriers to market entry while ensuring safety and consumer protection.

Component 3: Enhancing regional resilience. This will support efforts to establish the regional facility proposed under Component 1 and regional integration of payment systems and other financial infrastructures proposed under Component 2. It will finance upstream activities including the preparation of a feasibility study and market assessment needed for the establishment of the regional facility as well as analysis needed for development of a regional multilateral payment platform. It will support PICs to undertake corridor risk assessments to provide for a more risk-based approach to CBRs and will finance a contract for a third party to undertake customer due diligence (CDD) assessments of Pacific Island banks. The proposed regional facility and correspondent banks would use the corridor risk and CDD assessments as a basis for compliance with international AML/CFT standards and to facilitate international transactions with PICSs. Lastly, this component will include financing to support PICs with the implementation, management, and coordination of project activities. This includes fiduciary support; monitoring and evaluation; monitoring of environmental and social risks related to Project implementation; communication strategy, citizen engagement, social inclusion, and stakeholder coordination activities; operating costs, equipment, operational systems, consultants, GRM, training, and related technical assistance activities; internal audits; and tools, standards, training, and technical assistance to enhance transparency and stakeholder involvement.

Legal Operational Policies	**Triggered?**
Projects on International Waterways OP 7.50	No
Projects in Disputed Area OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

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Ministry of Finance of Solomon Islands

Ministry of Finance of Marshall Islands

Ministry of Finance of Tonga

Ministry of Finance of Vanuato

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Implementing Agencies

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APPROVAL

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