NATIONAL DEVELOPMENT BANK OF PALAU
(A COMPONENT UNIT OF THE REPUBLIC OF PALAU)

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2011 AND 2010

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INDEPENDENT AUDITORS' REPORT

Board of Directors
National Development Bank of Palau:

We have audited the accompanying statements of net assets of the National Development Bank of Palau (the Bank), a component unit of the Republic of Palau, as of September 30, 2011 and 2010, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Bank as of September 30, 2011 and 2010, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 10 to the financial statements, the Bank has deposits in an uninsured bank that is in receivership. Realization of these deposits is currently not determinable. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 27, 2012, on our consideration of the Bank's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 12 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Bank's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Deloitte & Touche LLC

September 27, 2012

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED SEPTEMBER 30, 2011

This Management Discussion and Analysis (MD&A) of the National Development Bank of Palau's (the Bank) financial performance and condition for the fiscal year ended 2011 is intended to contribute to the reader's better understanding of the Bank's structure and activities. The report should be read in conjunction with the audited financial statements and associated reports.

Note that this report may at times anticipate future events that are based upon current assumptions subject to risk and uncertainties. Actual events may differ materially from these expectations.

Organization of the Bank

The Bank is a corporation established to initiate and promote economic development in the Republic of Palau (ROP) and was created in February 1982 by Public Law Number 1-27 as codified in Title 26 of the Palau National Code, as amended. The Bank is wholly owned by ROP and operates independently under its own Board of Directors. Its main goals are to promote economic development by providing financing for new enterprise, industry, exports and housing.

The President of ROP appoints six of its seven Board members for three-year terms subject to Senate confirmation. These six Board members appoint the seventh Board member and the President of the Bank. The Board of Directors elects their own officers to the posts of Chairman, Vice Chairman and Secretary/Treasurer, to serve the length of their terms. Two Directors' terms expired in July 2011. One was later re-confirmed and a new member joined the Board at year end. The annual election of officers was held at year end and a new Chairman and Vice Chairman were elected. The Secretary/Treasurer was re-elected to the same position.

The Bank achieves its mission and goals by relending funds obtained from lenders, donors and the government. Its financial objective is not to maximize profit but to attain sufficient financial strength to achieve its objectives. Therefore, the Bank functions as a development financial institution and not a commercial or central bank. It is exempt from banking supervision by ROP's Financial Institutions Commission as long as it does not take in deposits; however, it is subject to prudential and reporting guidelines established by its Act and oversight hearings by either house of Congress at any time.

The Bank's Act has changed little since its last major revision. The most recent amendment was to specifically allow the Bank to lend to ROP. Several proposed amendments remain pending in Congress related to control over Bank's interest rates and terms and restrictions on Bank lending.

The Bank's policies and strategies are implemented through the Bank's President and management. Management consists of three managers organized by the functional areas of the Bank - Finance, Lending and Special Assets. During the year, a Special Assets position was eliminated due to complexities of collection measures that were better managed and dealt with by an outside attorney. The President of the Bank was also terminated under contract as the Board deemed it was time for a change given the large number of loans in collection that were not handled properly. The Bank operated for nearly six months with two managers. A total of twelve management and staff positions were filled during the year. This excludes a President and a Special Assets Manager who were no longer with the Bank.

Organization of the Bank, Continued

All Bank operations were conducted from its office in Ngetkib Village, Airai State. Plans for expansion of the Bank's building are set forth in the Bank's ten-year plan. During the year, the Bank made a small improvement by extending a self-contained storage within its premises to house a staff kitchen and to serve as an Energy Efficiency Subsidy Program (EESP) model area for clients. Aside from the main office, there were no branches, other offices or subsidiaries operating in 2011.

Significant Events in 2011

The performance of the Palau economy in 2011 was gradually stabilizing based on a moderate Gross Domestic Product growth of 2%. The continued effect of the weaker dollar and a sluggish U.S. economy are partly the cause, although rising fuel costs and delayed Congressional approval of the Compact of Free Association including the need for an improved investment regime in Palau are also believed to be contributing factors. Growth in the tourist market due to a new air carrier service to Palau offset some of these factors. This year, the government reported success in securing more stimulus funding from the Republic of China, Taiwan and Japan governments. A $16 million loan from the Asian Development Bank for water and sewer privatization also contributed to the economic recovery and stability.

The Bank focused on improving credit quality and collections on problem accounts during the year with more emphasis on several large accounts in distress. Major issues arising from problem accounts were improper documentation and a lack of consistent and equal treatment to all problem accounts. A need for further training on collections and monitoring of accounts was noted including more consolidated efforts and increased monitoring of new and existing accounts. The Bank also referred large accounts to an attorney outside of Palau (with experience in banking) to assist the Bank in litigating these cases. The Board further increased the general provision on loans from 3% to 5% in line with affected portfolio quality.

The Board of Directors' actions during the year also included the adoption of Key Performance Indicators to assist the Bank in monitoring its performance against its mandate, the Memorandum of Understanding (MOU) between the Bank and the Palau Public Utilities Corporation in support of on-grid solar panel installations for homes and businesses, the upgrade of the Bank's accounting and loan systems, the completion of the Ngermid Apartment Building foreclosed by the Bank and the implementation of the new Strategic Plan, which commenced in 2011, under the three-year rolling plan.

Funding for Operations

Historically, the Bank has funded its operations from three main sources: paid-in capital, accumulated retained income and borrowed funds. The most recent paid-in capital received from ROP was in the year 2000 for $3 million to fund a first-time homeowner program. The Bank has relied on accumulated retained income since 2002, and borrowed funds since 2003, to fund loan operations and the Bank's growth. Additional fund sources pursued during the year included additional long-term borrowings, loan/asset sales and grants. The Bank's Strategic Plan also considers deposit liabilities as a new source in the future.

Borrowed funds currently outstanding are from signed notes with Mega International Commercial Bank (MICB, previously the International Commercial Bank of China), the Republic of Palau Social Security Administration (ROPSSA), the European Investment Bank (EIB) and a cash-secured revolving line of credit with the Bank of Hawaii (BOH). The first three notes are for long-term intermediary relending funds. A balance remained on the EIB loan and an estimated $2 million was cancelled due to noncompliance on the EIB loan covenants resulting from two large accounts that went into arrears with no immediate resolution.

Funding for Operations, Continued

The Bank's BOH line of credit facility was opened as a short-term funding instrument. Cash security allows the Bank to reduce its cost of funds from this commercial facility. The line of credit is primarily utilized during periods when liquidity is low for funding loans. The Bank has maintained regular payments of principal for the line of credit to ensure that at renewal date it is fully available.

The Bank pursued an additional loan from ROPSSA, the sale of the Bank's housing portfolio and a possible new loan with MICB to secure loan funding for the next three years. A $750,000 loan from the U.S. Department of Agriculture (USDA) for an Intermediary Relending Program (IRP) was in process pending legislative action on a secured transaction act. The Bank is required to match these funds in a revolving fund at the signing of the loan. Loan funds are to be used to support micro, small and medium sized business projects while keeping customer affordability high with low interest rates. The Bank also worked to secure a grant to expand the Bank's Energy Loan Program to include the EESP for existing homes. These funds are granted for environmental projects under a concessionary interest rate. The program targeted for these funds includes the Bank's Energy Loan Program. The results of these efforts appear positive at the end of the year.

The timing and extent to which borrowed funds are utilized for lending activities is determined mainly by cost and availability. MICB loan proceeds represented the least costly funds available at a 3.5% fixed interest rate charged per annum. All proceeds from MICB have been drawn.

The Finance section of the Bank is accountable for accounting and financing activities including liquidity management. Liquidity management for the Bank includes segregation of bank accounts and transfers from general accounts to support disbursements. Disbursements are generally planned through the annual budget process. Forward estimates for loan disbursements are provided by line officers each month. Proceeds from loans to the Bank for intermediary re-lending are requested based on forward estimates and, where necessary, cash flow from operations, non-restricted investments and short-term credit line facilities are used if those proceeds are not immediately available. Management is mindful to minimize any additional interest costs in these decisions. Towards the end of the year, the Bank had drawn cash from its accounts to lower than historical levels.

Financial Policies

The Bank's financial policies follow accounting principles generally accepted in the United States of America (GAAP) applicable to governmental entities and specifically proprietary funds. Management is required to make estimates, disclosures and assumptions in preparation of financial statements in conformity with GAAP and actual results may differ from amounts reported during the reporting period. The basis of accounting used is the flow of economic resources measurement focus, which means all assets and liabilities are included within the statement of net assets. The accrual basis of accounting is utilized whereby revenues are recorded when earned and expenses recorded when liabilities are incurred.

Significant financial policies of the Bank include a 10% reserve requirement for the Bank's loan guarantees. These reserves are held in time certificates of deposit (TCDs) with commercial banks. The Bank maintained cash reserves of at least 10% for commercial bank guarantees throughout the year. Restricted deposits are also held as part of the requirements for the USDA Rural Development (USDA RD) for loans guaranteed by the Bank. These requirements are for fixed dollar and ratio amounts. The total reserve for commercial banks and USDA RD loans for 2011 was 15%.

All current guarantees are granted under recourse. The Bank offers 90% loan guarantees to local banks but the Bank may also guarantee up to 100% of select home loans from commercial banks made to Palauan citizens. The total amount for which the Bank was contingently liable in 2011 for commercial banks and USDA RD loans guaranteed by the Bank was $3.9 million. The amended MOU with USDA RD provided the requirements for accounts allowable for reserves and several procedural issues.

Financial Policies, Continued

Other financial policies include ROP's full faith and credit guarantee backing for Bank loans up to $15 million in the aggregate, subject to specific purpose limitations. Maximum Bank external borrowing authorized by ROP is $100 million. The maximum single exposure to a single borrowing entity was 20% of the Bank's unimpaired paid-up capital, earned surpluses and reserves. Specific targets for exposure to industry are not formally established but concentrations are monitored on a regular basis. Loan maturities are monitored to match borrowings, operation costs and long outstanding loan commitments. In September 2011, maturities were concentrated in the 15-year range.

Operations

Financial assistance is provided by the Bank for projects involving housing, agriculture, marine resources, commerce and industry. Emphasis is given to new enterprises or ventures that promote import substitution. Authorized financing schemes include guarantees, direct loans and direct investment. The Bank is also required to provide technical assistance services as part of its operations. The Bank's MOU and financial and logistical support with the Palau Small Business Development Center is an effort towards this responsibility. Information on other financial and technical service providers including government agencies is also provided for client or applicant consideration. Currently, the Bank's financial activities are limited to projects within ROP. All financial transactions are US dollar denominated.

<u>Direct loans</u>. Short to medium term financing is extended to new or existing businesses to fund short-term working capital and equipment acquisitions. Longer term financing is extended to individuals for housing and business facilities. Rates are fixed depending on the type of financing provided. Posted interest rates reported publicly by the Bank range from 6% to 10%. Certain accounts remain at 12% due to their non-performing status. Rates are considered to include the cost of funds and a lending spread to cover the cost of operations, a risk component and a small return for growth purposes. Fees are usually 2% of financing extended. Originating and closing costs are also charged to borrowers. Specific programs offered under direct financing are agriculture, fishing, small business, housing and business loans. In 2011, the Bank approved one hundred twenty-six loan applications. This includes renewals, extensions, performance bonds, cancelled loans and guarantees. Loans approved amounted to $4.3 million with $4.9 million undisbursed at year end (including some approvals from prior years). Fifty-five accounts were in various stages of implementation with seven approved but not booked. Undisbursed loans also included eighteen line of credit and bonding accounts.

In the category of small business loans, the Bank offers customers four programs: Small Business, WEDAP, Microfinance and its newest program, Pre-Development Loan. All of these loans can be approved by the Bank's President. The Bank's general policy is all loans are fully secured. The Bank's Microfinance program and Pre-Development Loan are small loans for housing or business purposes at a 6% interest rate targeting those borrowers who are able to secure their loan with an assignment of income. No collateral is required and turnover is intended to be quick. These programs appear to be successful and are popular. Specifically, interests in Microfinance Loans, which are also available for home projects such as extensions and renovations have been popular. This may be due to the postponement of larger investments by borrowers due to the current sentiment regarding a weak economy.

Direct housing loans are provided in two categories, the first time homeowner program which offers an 8% interest rate and all other housing loans at a 10% interest rate. Owner contribution to projects is required at 15% of project cost with a maximum amount of $10,000 under the Pre-Development Loan and a loan term not to exceed five years. The purpose of Pre-Development Loan is to help borrowers pay for plan design, appraisal, title search and all related fees associated with packaging loans and cash equity contribution. Eligible purposes for housing loans include new construction, renovation and extension. Most loans granted are for new construction. The Bank has observed more loans being approved under the first-time homeowner program than the standard housing program.

Operations, Continued

Guarantees. The Bank offers guarantees either backed by the Bank or ROP to commercial banks and other institutions. Commercial banks, government authorities and the regional development financial institution, the Pacific Island Development Bank, either currently accept or hold guarantees from the Bank. The majority of guarantees outstanding from the Bank are to USDA RD loans. In addition to the for USDA RD Section 502 and 504 loans guaranteed by the Bank, there are the leveraged loans which are co-financed by both the Bank and the USDA RD. Popularity is low with these programs as they often take months to receive approval and are stricter in terms and standards enforced.

Investments. There were no further investments made by the Bank since its initial investment in Palau Micronesia Air which has been repurchased by other stockholders. However, the Bank has taken an assignment of an $820,000 note between ROP and the Receivership for Pacific Savings Bank for the purpose of assisting certain classes of depositors in the lower bracket. The assignment of the note bears no interest and monthly payments of $10,000 previously paid to ROP was directed and assigned to the Bank. In 2011, the Bank disbursed $320,000 of the $820,000 with the remaining $500,000 to be disbursed at a later date.

Approval Process. All requests for financing are reviewed by loan officers who recommend approval or declination of a loan based on review of business and other plans, income and credit verifications and collateral. A normal approval cycle from application to approval can be obtained within three months with the exception of small loans approved by the President that can be approved within three weeks. The use of outside professionals to research land title, provide valuations on collateral, review and certify plans and conduct progress inspections is an integral part of loan origination but also delays loan approvals. The Bank advocates building codes and requires the use of a recognized code in the design of all construction projects. The Bank utilizes a dual approval process whereby the next higher approval authority reviews loan decisions. The Bank's Board of Directors holds meetings of no less than three times per month to approve loans and review other business. Loan disbursements are made according to progress payments against approved loan purposes. Any deviation requires an amendment to the loan and approval by original approving authorities.

Loan Management. The Bank monitors payment performance and contacts client on a seven, thirty, sixty and ninety day schedule with the degree of reporting based on each borrowers' circumstance. Officers also conduct account reviews and site visits whenever a weakness becomes evident in a loan. As loans approach the ninety day delinquency, the Special Asset Manager or Compliance Officer intervenes and assists the Account Officer with recovery or rehabilitation of the loan.

Financial Reporting. Financial reporting is made by each of the Bank's three sections and the President on a monthly basis. These reports include financial, loan and collection information as well as administrative, industry and economic environment information. Monthly and quarterly reports are provided to the Board of Directors and annual reports provided to lenders and ROP.

Overview of Financial Performance

Revenue. 2011 revenue, including loan fees and interest income on interest bearing accounts was up 16% from 2010 mainly due to fees and charges on loans. Revenue yield decreased by 17 points due to a proportionately larger amount of lower interest rate loans approved and booked. There was an increase of lending activities to support performance bond and business line of credits as directly associated with increased fees earned this year. There were two loans charged-off for the year with lesser accounts in non-accrual status that contributed to the revenue performance. At the end of the year, total revenues were lower than the Bank's budget by 7% mainly due to a slow growth of the portfolio resulting from delays in funding from outside sources. Source of funds to be used in 2012 is expected to increase the portfolio to the level planned for under the three-year rolling plan.

Overview of Financial Performance, Continued

2010 revenue, including loan fees and interest income on interest bearing accounts, increased 1% from 2009 due to write-offs and placement of loans on non-accrual status. Over $245,000 was reversed from interest income in May 2010 for loans placed on non-accrual status. Revenue yield decreased due to a proportionately larger amount of lower interest rate loans approved and booked. The largest of these loans was $3,000,000 to a public corporation for equipment purchasing. At the end of the year, loans were also written-off resulting in 17% lower revenues than the Bank's budget estimates.

Interest income on interest bearing accounts and revenues from loan fees and charges also supported revenue levels. Cash was drawn from savings accounts to fund loan operations reducing balances which, combined with lower interest rates due to weakness in the global economy, resulted in a reduction in income from interest bearing accounts from 2010. The Bank amortizes loan fees and the annual portion of loan fees is reported as income in the current period.

Loan Interest Rates. The Bank's interest rates remained fixed according to the type of loan activity funded. Rates ranged from a low of 6% for agriculture, microfinance and pre-development loans to 8% for fishing and first-time homeowner loans and 10% for commercial and housing loans. Rates for several problem loan accounts in the process of collection remain at 12%. Other accounts in collection continue to be assessed a 9% interest rate as required by a court-ordered judgment. At the end of this reporting period, the average yield on the Bank's portfolio declined from 8.58% in 2010 to 8.41% as loan growth continued in lower interest rate loan programs. For 2010 the average yield on the Bank's portfolio declined from 8.85% in 2009 to 8.58% as loan growth continued in lower interest rate loan programs.

Grant Requests. The Bank continued to draw on the cash received from a $500,000 grant implemented in 2009 for the EESP. The Bank received a $400,000 grant in 2010 for the Renewable Energy Subsidy Program (RESP) for solar panel purchase and installation. The EESP and RESP provide energy subsidy assistance for customers building new homes and for commercial purposes. The $503,219 in grant revenues of 2011 were from these programs under the Energy Loan Program of the Bank. In 2010 the $81,767 in grant revenues were from EESP.

Expenses. The Bank's net provision for loan losses in 2011 was $976,280 as additional provisions were made and specific provisions were made for large delinquent accounts at the end of the fiscal year. The increase in the provision for loan losses in 2011 was mainly due to a general provision that was increased from 3% to 5% in July 2011. Provisions are net of recoveries for the year. Interest expense savings for the Bank versus budget reflected the Bank's reduction in cash balances to fund lending and low interest rates due to a weakened global economy. The Bank's net provision for loan losses in 2010 was $761,397 as additional provisions were made and specific provisions were made for large delinquent accounts at the end of fiscal year.

Total operating expenses for 2011 was 4% higher than 2010 expenses and 9.1% above budget. Savings were realized in rent, training, travel and other expenses. The Bank's commitment for training new and existing staff with internet-based, bank-designed and off-island training continues each year. Depreciation costs increased as further improvements to the Bank's leasehold were recorded. A new vehicle was also procured to replace an existing vehicle which was fully depreciated. Salaries increased mainly due to health care insurance that took effect in 2011. The Bank's Energy Loan Program, which included the procurement and installation of specially designed solar photovoltaic equipment on Bank premises, is part of its energy savings policy, demonstration of technology and training of installers. Total operating expenses for 2010 was 3% higher than 2009 expenses and 6.6% under budget. Savings were realized in salary, training, travel and depreciation.

Change in Net Assets. The change in net assets was positive for the year resulting largely from a grant received for the Energy Loan Program and increases in fee and interest income on loans. A condensed year-to-year comparison of operating activity reflecting the foregoing statements follows:

Overview of Financial Performance, Continued

Statements of Revenues, Expenses and Changes in Net Assets

	2011	2010	$ Change	% Change	2009
Revenues:					
Interest income on loans	$ 2,241,902	$ 1,953,169	$ 288,733	15%	$ 1,938,063
Loan fees and late charges	94,990	66,428	28,562	43%	59,191
Other	6,073	6,412	(339)	-5%	6,420
Total operating revenues	2,342,965	2,026,009	316,956	16%	2,003,674
Provision for loan losses	(976,280)	(761,397)	(214,883)	28%	(247,078)
Operating expenses:					
Salaries, wages and fringe benefits	481,722	432,754	48,968	11%	416,497
Rent	1,000	10,415	(9,415)	-90%	42,568
Depreciation	52,530	42,366	10,164	24%	35,297
Training	25,554	32,094	(6,540)	-20%	2,065
Other expenses	323,096	335,580	(12,484)	-4%	331,255
Total operating expenses	883,902	853,209	30,693	4%	827,682
Operating income	482,783	411,403	71,380	17%	928,914
Total non-operating revenues (expenses), net	(177,819)	(500,217)	322,398	-64%	(330,740)
Change in net assets	304,964	(88,814)	393,778	-443%	598,174
Net assets at beginning of year	15,608,233	15,697,047	(88,814)	-1%	15,098,873
Net assets at end of year	$ 15,913,197	$ 15,608,233	$ 304,964	2%	$ 15,697,047

A condensed year-to-year comparison of the Statements of Cash Flows follows:

Statements of Cash Flows

	2011	2010	$ Change	% Change	2009
Cash flows from operating activities	$ 1,597,634	$ 1,194,094	$ 403,540	34%	$ 1,028,137
Cash flows from capital and related financing activities	(1,374,963)	172,692	(1,547,655)	-896%	4,624,098
Cash flows from investing activities	(774,865)	(2,130,354)	1,355,489	-64%	(4,745,518)
Cash flows from noncapital financing activities	235,044	333,643	(98,599)	-30%	(53,828)
Net decrease in cash and cash equivalents	(317,150)	(429,925)	112,775	-26%	852,889
Cash and cash equivalents at beginning of year	1,271,165	1,701,090	(429,925)	-25%	848,201
Cash and cash equivalents at end of year	$ 954,015	$ 1,271,165	$ (317,150)	-25%	$ 1,701,090

The table above reflects $731,390 paid for long-term debt financing activities. The Bank anticipates loan proceeds to be the major funding source in 2012.

Overview of Financial Condition

Loan Portfolio. The Bank approved one hundred twenty-six loans including line renewals and amendments, amounting to $6.2 million in 2011 compared to its $4.5 million budget. The larger number of loans extended reflected full staffing in the loan section as well as the success of the Microfinance and Pre-Development Loan programs in 2011. The number of applications was steadily received throughout the year following individualized target clients and the Bank's participation in various community events. The Bank approved one hundred and fifty-six loans including line renewals and amendments, amounting to $12.4 million in 2010 compared to its $6.4 million budget.

Overview of Financial Condition, Continued

The Bank's goal during the year remained growth in income and assets while maintaining credit quality. Emphasis was also made towards increasing the commercial sector portfolio which was challenging given the less than favorable industry and economic conditions. Simultaneously, emphasis was placed on adjusting the portfolio distribution to reduce exposure and diversify risk. As the economy weakened, growth in the housing portfolio slowed in comparison to business loan growth which tends to be for larger amounts. The downside of this effect was felt in 2011 when three large accounts in the commercial sector fell delinquent. The impact affected the substantial reduction in value of the commercial loan portfolio and placed the Bank in a precarious situation in complying with certain borrowing covenants. Commercial loans, as a share of the portfolio, decreased to 56% of the Bank's loan portfolio compared to 59% the year before. The proportion of loans by major sector follows. Note that Microfinance loans are also included in the housing loan category. Many of these loans were for renovations and improvements to existing dwellings. Outstanding loans by type of loan for 2011 and 2010 are as follows:

	2011			2010		
Sector	**Number**	**Amount**	**%Value**	**Number**	**Amount**	**%Value**
Agriculture	13	$ 61,518	0.22%	13	$ 117,961	0.41%
Fishing	11	56,823	0.20%	8	46,877	0.16%
Commercial	128	15,605,482	56.30%	115	16,756,446	58.57%
Housing	481	11,995,692	43.28%	411	11,690,802	40.86%
		$ 27,719,515	100.00%		$ 28,612,086	100.00%

The total number of loans on the Bank's books at year end was six hundred thirty-three. The Bank did not sell any of its loans/assets in 2011 and no participated loans were made. Discussions for the purchase of the Bank's loans/assets in 2011 on a full recourse basis were unsuccessful due to several factors including current economic conditions. At 2010, the total number of loans on the Bank's books at year end was 457.

Arrears. The total number of accounts with amounts in arrears and notes past maturity (over ninety days) at the end of 2011 was fifty-eight accounts amounting to $804,000. The amount of arrears as a percentage of the value of outstanding notes at the end of 2011 was close to 2.9%. For 2010, the total number of accounts with amounts in arrears and notes past maturity (over 90 days) at the end of 2010 was 51 accounts amounting to $829,000. The amount of arrears as a percentage of the value of outstanding notes at the end of 2010 was close to 2.8%.

New Debt. The Bank used and renewed a $300,000 line of credit with a commercial bank to support its liquidity needs. This facility is for a one year term and is renewable. The Bank maintained a deposit of $400,000 with the same commercial bank securing this line of credit. See notes 6 and 7 to the financial statements for more information on the Bank's loans payable.

Net Assets. The Bank's overall change in net assets for 2011 and 2010 was $304,964 and ($88,814), respectively. Net increase in capital assets for 2011 was $10,220 reflective of additional improvements of the Bank's building in Airai. For 2010, the Bank's overall change in net assets for 2010 and 2009 was $(88,814) and $598,174 respectively. Net increase in capital assets for 2010 was $148,140 reflective of additional improvements of the Bank's building in Airai.

Plant and Equipment. At September 30, 2011, 2010 and 2009, the Bank had $738,082, $727,862 and $579,722, respectively, invested in capital assets, net of accumulated depreciation where applicable, including leasehold rights, furniture, fixtures and equipment, vehicles and leasehold improvements and construction in progress, which represents a net increase in 2011 of $10,220 or 1% over 2010, a net increase in 2010 of $148,140 or 26% over 2009 and a net increase in 2009 of $50,892 or 10% over 2008. See note 4 to the financial statements for more information on the Bank's plant and equipment.

Overview of Financial Condition, Continued

The following condensed Statements of Net Assets highlights the aforementioned changes in condition with comparative information from prior years.

Statements of Net Assets

	2011	2010	$ Change	% Change	2009
Current and other assets	$ 29,288,972	$ 29,587,138	$ (298,166)	-1%	$ 28,698,390
Capital assets	738,082	727,862	10,220	1%	579,722
Total assets	$ 30,027,054	$ 30,315,000	$ (287,946)	-1%	$ 29,278,112
Loans payable	$ 13,803,832	$ 14,538,223	$ (734,391)	-5%	$ 13,301,696
Other liabilities	310,025	168,544	141,481	84%	279,369
Total liabilities	$ 14,113,857	$ 14,706,767	$ (592,910)	-4%	$ 13,581,065
Net assets:					
Invested in capital assets	$ 738,082	$ 727,862	$ 10,220	1%	$ 579,722
Restricted	15,175,115	14,880,371	294,744	2%	15,117,325
Total net assets	$ 15,913,197	$ 15,608,233	$ 304,964	2%	$ 15,697,047

Affiliations

The Bank's membership and partnership affiliations locally and abroad include the Palau Chamber of Commerce, the American Bankers Association, the Risk Management Association, various foreign government agencies, the Association of Development Finance Banks and the Association of Development Finance Institutions in Asia and the Pacific. Benefits received from these associations include information exchanges, professional networking and training opportunities.

Risk Management

Primary risks the Bank faces include Strategic/Operational, Credit, Technology, Economic, Reputation/Political and Climatic/Environmental risks (in no particular order). The Board of Directors manages these risks with the assistance of management.

Monitoring is conducted primarily through management and external audit reporting. Mandatory reporting to the National Government is also provided during the National budget process and through specific reporting requirements under the Bank's enabling legislation.

Loss Provisioning. The Bank's provisions for loan losses with a general provision of 5% and specific provisions of 20%, 50% and 100% depending on the extent loans are past due and the value of security held as collateral. The Bank manages its loans by assigning credit and security risk ratings to each account.

Loans and associated security are rated on a scale ranging from "A thru F" similar to the World Bank system. All loans are individually managed by this system. Loan accounts are required to be reviewed regularly.

Decisions to place loans on non-accrual of income status are made according to Bank policy which also provides that loans may be held on accrual if justified by the Bank Officer. As of September 30, 2011, forty-one loans amounting to $3.7 million (payoff balance) were on non-accrual status.

Economic Outlook

Activities of significance planned in 2012 include implementation of the Bank's energy loan product on renewable energy, receipt of an additional $454,545 in grants to support that program, recording of the $750,000 USDA IRP loan and further borrowings from the MICB, ROPSSA and EIB. Additional credit training and technical assistance for capacity building and client support are also planned. The development of these activities relies upon improving global economy and reduced uncertainty in the local market. The target for loan approvals in the new year will be $7 million with lending increases in the agriculture and fisheries sectors.

Contacting the Bank's Financial Management

This financial report is designed to provide a general overview of the Bank's finances and to demonstrate the Bank's accountability for the money it receives. The MD&A for the year ended September 30, 2010 is set forth in the report on the audit of the Bank's financial statements which is dated March 29, 2011. That Discussion and Analysis explains the major factors impacting the 2010 financial statements. If you have questions about the 2010 or 2009 reports, or need additional information, please contact the Finance Manager at the National Development Bank of Palau, P.O. Box 816, Koror, Republic of Palau 96940, or e-mail frirou@ndbp.com or call 488-2578/3955.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Net Assets
September 30, 2011 and 2010

ASSETS	2011	2010
Current assets:		
Cash and cash equivalents	$ 954,015	$ 1,271,165
Restricted time certificates of deposit	451,300	449,520
Receivables:		
Current portion of economic development loans receivable, net	5,511,547	5,960,782
Accrued interest	305,128	416,457
Other receivables, net of allowance for doubtful accounts of $91,602 and $-0- as of September 30, 2011 and 2010, respectively	398,300	224,742
Inventory	365,865	9,371
Prepaid expenses	37,312	33,221
Total current assets	8,023,467	8,365,258
Restricted cash and cash equivalents	573,431	600,066
Time certificates of deposit	205,112	205,112
Economic development loans receivable, net	18,544,071	20,049,484
Property and equipment, net	738,082	727,862
Foreclosed real estate	1,942,891	367,218
	$ 30,027,054	$ 30,315,000

LIABILITIES AND NET ASSETS	2011	2010
Current liabilities:		
Short-term loan payable	$ 300,000	$ 300,000
Current portion of loans payable	894,760	788,084
Due to grantor	218,869	100,689
Accounts payable and accrued expenses	91,156	67,855
Interest payable	118,192	121,193
Total current liabilities	1,622,977	1,377,821
Loans payable, net of current portion	12,490,880	13,328,946
Total liabilities	14,113,857	14,706,767
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	738,082	727,862
Restricted	15,175,115	14,880,371
Total net assets	15,913,197	15,608,233
	$ 30,027,054	$ 30,315,000

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2011 and 2010

	2011	2010
Operating revenues:		
Interest income on loans	$ 2,241,902	$ 1,953,169
Loan fees and late charges	94,990	66,428
Other	6,073	6,412
Total operating revenues	2,342,965	2,026,009
Provision for loan losses and doubtful accounts	(976,280)	(761,397)
Net operating revenues	1,366,685	1,264,612
Operating expenses:		
General and administrative expenses:		
Salaries, wages and fringe benefits	481,722	432,754
Professional fees	94,446	123,455
Travel and transportation	86,926	87,795
Depreciation	52,530	42,366
Training	25,554	32,094
Dues and subscriptions	21,030	8,452
Utilities	20,502	20,894
Repairs and maintenance	18,247	9,936
Honorariums and meeting expense	15,710	12,325
Supplies, printing, and reproduction	14,923	15,820
Communications	10,698	10,930
Insurance	8,335	7,104
Rent	1,000	10,415
Miscellaneous	32,279	38,869
Total general and administrative expenses	883,902	853,209
Operating income	482,783	411,403
Nonoperating revenues (expenses), net:		
Grant revenues	503,219	81,767
Rental income	17,500	30,000
Gain on sale of property and equipment	4,568	4,500
Interest income on interest bearing accounts	3,680	34,969
Other income	2,171	5,895
Interest expense and loan fees	(579,496)	(575,581)
Energy Efficiency Home Loan Project	(100,400)	(81,767)
Energy Loan Program	(29,061)	-
Total nonoperating revenues (expenses), net	(177,819)	(500,217)
Change in net assets	304,964	(88,814)
Net assets at beginning of year	15,608,233	15,697,047
Net assets at end of year	$ 15,913,197	$ 15,608,233

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Cash Flows
Years Ended September 30, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Cash received from customers	$ 2,453,986	$ 2,035,267
Cash payments to employees for services	(465,793)	(433,670)
Cash payments to suppliers for goods and services	(390,559)	(407,503)
Net cash provided by operating activities	1,597,634	1,194,094
Cash flows from capital and related financing activities:		
Proceeds from issuance of long-term debt	-	1,500,000
Acquisition of property and equipment	(64,283)	(190,506)
Repayments of long-term debt	(731,390)	(575,989)
Interest paid on long-term debt	(579,290)	(560,813)
Net cash (used for) provided by capital and related financing activities	(1,374,963)	172,692
Cash flows from investing activities:		
Net change in time certificates of deposit	(1,780)	2,611,668
Interest received on interest bearing deposits	3,988	31,219
Gain on sale of property and equipment	6,101	4,500
Net change in restricted cash and cash equivalents	26,635	(1,765)
Loan originations and collections, net	(809,809)	(4,775,976)
Net cash used for investing activities	(774,865)	(2,130,354)
Cash flows from noncapital financing activities:		
Proceeds from short-term borrowings	300,000	600,000
Rental income received	17,500	30,000
Other income received	2,171	5,895
Cash received from grantor	218,580	-
Interest paid on short-term borrowings	(3,207)	(2,252)
Repayments of short-term borrowings	(300,000)	(300,000)
Net cash provided by noncapital financing activities	235,044	333,643
Net decrease in cash and cash equivalents	(317,150)	(429,925)
Cash and cash equivalents at beginning of year	1,271,165	1,701,090
Cash and cash equivalents at end of year	$ 954,015	$ 1,271,165
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 482,783	$ 411,403
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	52,530	42,366
Provision for loan losses and doubtful accounts	976,280	761,397
(Increase) decrease in assets:		
Interest receivable	111,021	9,258
Other receivables	(45,160)	(10,612)
Inventory	970	(655)
Prepaid expenses	(4,091)	9,995
Increase (decrease) in liabilities:		
Accounts payable and other liabilities	23,301	(29,058)
Net cash provided by operating activities	$ 1,597,634	$ 1,194,094

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Cash Flows, Continued
Years Ended September 30, 2011 and 2010

	2011	2010
Supplemental schedule of noncash investing activities:		
Foreclosed real estate transferred from loans:		
Increase in foreclosed real estate	$ 1,575,673	$ 102,140
Decrease in economic development loans receivables	(1,575,673)	(102,140)
	$ -	$ -
Contributions:		
Increase in inventory	$ 357,464	$ -
Increase in economic development loan receivables	45,355	-
Increase in grant revenues	(402,819)	-
	$ -	$ -
Subsidy for Energy Efficiency Home Loan Project and Energy Loan Program:		
Increase in Energy Efficiency Home Loan Project	$ 100,400	$ -
Increase in Energy Loan Program	29,061	-
Decrease in economic development loans receivables	(129,461)	-
	$ -	$ -

See accompanying notes to financial statements.

(1) Organization

The National Development Bank of Palau (the Bank), a component unit of the Republic of Palau (ROP), was formed on February 24, 1982, under the provisions of Republic of Palau Public Law (RPPL) No. 1-27, as amended by RPPL 3-4, 4-48, 5-37 and 6-18. The law created a wholly-owned government corporation managed by a Board of Directors appointed by the President of ROP with the advice and consent of the Olbiil Era Kelulau (OEK - Palau National Congress). The purpose of the Bank is to be the central financial institution responsible for initiating and promoting economic development within ROP, and considers all of its net assets, except net assets invested in capital assets, to be restricted for such purposes.

(2) Summary of Significant Accounting Policies

The accounting policies of the Bank conform to accounting principles generally accepted in the United States of America (GAAP), as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Bank has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

A. Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of this fund are included within the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred.

B. Cash and Cash Equivalents and Time Certificates of Deposit

For the purpose of the statements of net assets and cash flows, the Bank considers all highly liquid investments, with maturities of three months or less when purchased, to be cash and cash equivalents. Time certificates of deposit with initial maturities of greater than three months are separately classified. The Bank does not require collateralization of its bank accounts. Cash and cash equivalents and time certificates of deposit maintained in Federal Deposit Insurance Corporation (FDIC) insured banks amounted to $2,005,630 and $2,378,883 at September 30, 2011 and 2010, respectively. Bank deposits of $1,004,981 and $750,000 were FDIC insured at September 30, 2011 and 2010, respectively.

(2) Summary of Significant Accounting Policies, Continued

B. Cash and Cash Equivalents and Time Certificates of Deposit, Continued

Time certificates of deposit maintained in an uninsured bank amounted to $205,112 at September 30, 2011 and 2010. The Bank does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

RPPL 4-48, Section 126, as amended by RPPL 5-37, stipulates that the Bank shall maintain a reserve account to be applied to all defaults on commercial loans guaranteed by the Bank. The reserve account shall equal ten percent (10%) of the total amount of all loan guarantees on commercial bank loans, whether or not protected by the full faith and credit of ROP. The Bank has restricted $50,047 of cash and cash equivalents as of September 30, 2011 and 2010 to comprise this reserve. The Bank has also restricted cash and cash equivalents held solely for the guarantee of U.S. Department of Agriculture Rural Development (USDA RD) loans in the amount of $523,384 and $550,019 as of September 30, 2011 and 2010, respectively.

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

Category 1 Deposits that are federally insured or collateralized with securities held by the Bank or its agent in the Bank's name;

Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Bank's name; or

Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Bank's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Bank does not have a deposit policy for custodial credit risk.

C. Loans and Allowance for Loan Losses

The Bank grants loans to eligible borrowers, including affiliates, officers and employees, all of which are located in ROP. Loans are stated at the amount of unpaid principal and interest, reduced by an allowance for loan losses and deferred loan origination fees.

(2) Summary of Significant Accounting Policies, Continued

C. Loans and Allowance for Loan Losses, Continued

Loan origination fees are deferred and amortized to income as an adjustment of yield using the straight-line method over the contractual life of the loans. Direct loan origination costs are expensed as incurred. Differences between this method and the method prescribed by FASB ASC 310-20, *Receivables: Nonrefundable Fees and Other Costs* are not significant and do not otherwise materially affect the accompanying financial statements.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may be uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrowers' ability to pay.

D. Inventory

Inventory of on-grid and off-grid solar photovoltaic systems and commemorative coins are stated at the lower of cost (first-in, first-out) or market.

In 2011, the Bank implemented the Energy Loan Program to provide loans to business and housing customers to acquire renewable energy technologies. The Bank received on-grid and off-grid solar photovoltaic systems amounting to $402,819 from the United Nations Development Programme through the ROP Energy Office under the Sustainable Economic Development through Renewable Energy Applications (SEDREA) Program. As of September 30, 2011, inventory of on-grid and off-grid solar photovoltaic systems amounted to $357,464.

E. Property and Equipment

Property and equipment are stated at cost. The Bank capitalizes property and equipment with cost exceeding $1,000. Depreciation is provided using the straight-line basis over the estimated useful lives of the respective assets.

F. Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, loan foreclosures are held for sale and are initially recorded at the lower of the carrying amount of the loan or the fair value of the property at the date of foreclosure less estimated selling costs. Write-downs of the asset at, or prior to, the date of foreclosure are charged to the allowance for losses on loans. Subsequent write downs, income and expense incurred in holding such assets, and gains and losses realized from the sales of such assets are included in current operations.

(2) Summary of Significant Accounting Policies, Continued

G. Revenue Recognition

Operating revenues include all direct revenues such as interest and fees on loans and interest on investments.

Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when principal or interest payments are delinquent ninety days or more, or when, in the opinion of the Bank, there is an indication that the borrower may be unable to meet payments as they become due. Interest income thereafter is recognized only to the extent of cash payments received. Nonaccrual loans approximated $3,725,356 and $4,262,932 at September 30, 2011 and 2010, respectively.

H. Net Assets

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, has required the Bank to establish net asset categories as follows:

- Invested in capital assets; capital assets, net of accumulated depreciation.

- Restricted:

  Nonexpendable - Net assets subject to externally imposed stipulations that the Bank maintains them permanently. At September 30, 2011 and 2010, the Bank does not have nonexpendable net assets.

  Expendable - Net assets whose use by the Bank is subject to externally imposed stipulations that can be fulfilled by actions of the Bank pursuant to those stipulations or that expire by the passage of time. As described in note 1, the Bank considers all assets, except investments in capital assets, to be restricted for economic development.

- Unrestricted; net assets that are not subject to externally imposed stipulations. As the Bank considers all assets, except investments in capital assets, to be restricted for economic development, the Bank does not have unrestricted net assets of September 30, 2011 and 2010.

I. New Accounting Standards

During fiscal year 2011, the Bank implemented the following pronouncements:

- GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions.

- GASB Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools.

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements, which* addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus, which* is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity, and No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

In July 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In July 2011, GASB issued Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions* (an amendment of GASB Statement No. 53), which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The provisions of this statement are effective for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

J. Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and loan guarantees. Such financial instruments are recorded in the financial statements when they become payable. At September 30, 2011 and 2010, the Bank had no such off-balance sheet financial instruments.

(3) Economic Development Loans and Allowance for Loan Losses

The components of loans receivable as of September 30, 2011 and 2010 are as follows:

	2011	2010
Loans receivable	$ 27,719,515	$ 28,612,086
Less:		
Allowance for loan losses	(3,467,562)	(2,431,451)
Deferred loan origination fees	(196,335)	(170,369)
	24,055,618	26,010,266
Current portion of economic development loans receivable	(5,511,547)	(5,960,782)
	$ 18,544,071	$ 20,049,484

(3) Economic Development Loans and Allowance for Loan Losses, Continued

Maturities of the above principal balances subsequent to September 30, 2011, will be as follows:

Fully matured and others	$ 35,162
1 - 6 months	521,614
7 - 18 months	2,955,733
19 months - 3 years	1,340,627
After 3 years	22,866,379
	$ 27,719,515

An analysis of the change in the allowance for loan losses is as follows:

	2011	2010
Balance - beginning of year	$ 2,431,451	$ 1,889,054
Recoveries of loan previously charged-off	234,977	206,350
Provision for loan losses	884,678	761,397
Loans charged-off	(83,544)	(425,350)
Balance - end of year	$ 3,467,562	$ 2,431,451

(4) Plant and Equipment

A summary of plant and equipment as of September 30, 2011 and 2010, is as follows:

	Estimated Useful Lives	Balance at October 1, 2010	Additions	Deletions	Balance at September 30, 2011
Depreciable assets:					
Leasehold rights	39 - 50 years	$ 493,206	$ -	$ -	$ 493,206
Furniture, fixtures and equipment	2 - 20 years	192,491	7,330	(58)	199,763
Vehicles	5 years	64,395	33,059	(22,995)	74,459
Leasehold improvement	5 years	225,880	23,894	-	249,774
		975,972	64,283	(23,053)	1,017,202
Less accumulated depreciation		(248,110)	(52,530)	21,520	(279,120)
		$ 727,862	$ 11,753	$ (1,533)	$ 738,082

	Estimated Useful Lives	Balance at October 1, 2009	Additions	Transfer	Deletions	Balance at September 30, 2010
Depreciable assets:						
Leasehold rights	39 - 50 years	$ 493,206	$ -	$ -	$ -	$ 493,206
Furniture, fixtures and equipment	2 - 20 years	184,748	18,463	-	(10,720)	192,491
Vehicles	5 years	63,495	19,400	-	(18,500)	64,395
Leasehold improvement	5 years	2,164	-	225,880	(2,164)	225,880
		743,613	37,863	225,880	(31,384)	975,972
Less accumulated depreciation		(237,128)	(42,366)	-	31,384	(248,110)
		506,485	(4,503)	225,880	-	727,862
Non-depreciable assets:						
Construction in progress		73,237	152,643	(225,880)	-	-
		$ 579,722	$ 148,140	$ -	$ -	$ 727,862

(5) Foreclosed Real Estate

A summary of the changes in foreclosed real estate as of September 30, 2011 and 2010 is as follows:

	2011	2010
Balance at beginning of year	$ 367,218	$ 271,078
Additions	1,575,673	102,140
Disposals	-	(6,000)
Balance at end of year	$ 1,942,891	$ 367,218

Title to foreclosed real estate of $1,915,891 and $340,218 is in the Bank's name as of September 30, 2011 and 2010, respectively.

(6) Short-Term Loans Payable

The Bank entered into a $300,000 revolving credit line (credit line) with a local bank on October 27, 2007 for the purpose of supplementing disbursements of approved loans and temporary cash requirements to fund operations. On October 21, 2008, the Bank renewed the credit line under essentially the same terms and conditions. Repayment of the credit line is due one year from the initial drawdown with interest at the time certificate of deposit (TCD) rate, plus 1.50% (1.75% and 2.00% at September 30, 2011 and 2010, respectively). The credit line is collateralized by an assignment of $451,300 and $449,520 in TCDs as of September 30, 2011 and 2010, respectively.

Changes in short-term loans payable for the years ended September 30, 2011 and 2010, are as follows:

	Balance October 1, 2010	Additions	Reductions	Balance September 30, 2011	Due Within One Year
Short-term loans payable	$ 300,000	$ 300,000	$ (300,000)	$ 300,000	$ 300,000

	Balance October 1, 2009	Additions	Reductions	Balance September 30, 2010	Due Within One Year
Short-term loans payable	$ -	$ 600,000	$ (300,000)	$ 300,000	$ 300,000

(7) Loans Payable

On August 28, 2003, the Bank entered into a loan with the Republic of Palau Social Security Retirement Fund (the Fund), an affiliated entity and a component unit of ROP. The loan was for $3,000,000 with a subsequent $2,000,000 line of credit to be made available with terms and conditions to be agreed to by the parties at that time.

(7) Loans Payable, Continued

On August 7, 2008, the Bank entered into a new loan agreement to restructure the existing loan with the Fund. The loan ceiling increased to $6,000,000 which will be disbursed in increments of $500,000, bearing interest at a variable annual rate equal to the Fund's Fixed Income Fund Return Rate as reported monthly by Fund's investment consultant, plus 0.5%; provided, however that the interest rate to be charged and paid shall not be less than 4.5% nor more than 7.5% after addition of the 0.5% to the prime rate. Outstanding principal plus all unpaid interest is to be paid semi-annually, on or before June 30 and December 31 of each year, effective June 30, 2011 up to December 31, 2025.

The loan was $5,856,694 and $6,000,000 with interest at 4.5% as of September 30, 2011 and 2010, respectively. The loan is collateralized by the full faith and credit of the ROP Government.

On March 5, 2004, the Bank entered into a loan with Mega International Commercial Bank Co., Ltd. (formerly the International Commercial Bank of China) for $5,000,000 to be used as capital funds for the Bank. The note is uncollateralized and is due on July 1, 2024, with interest fixed at 3.5% per annum, payable in semi-annual installments of $142,858, and guaranteed by ROP. Interest is payable semi-annually and commences six months after the advance of proceeds. Annual expected principal repayments are $285,716.

On December 5, 2006, the Bank entered into an agreement with the European Investment Bank (EIB) to borrow up to 5,000,000 euros, which will be converted to U.S. dollars at the effective exchange rate upon disbursement. The available credit shall be drawn in tranches upon written request by the Bank. Loan proceeds may be used for purposes of financing 50% of the total cost of projects and portfolio projects of the Bank. The agreement is backed by the full faith and credit of the government of ROP. As of September 30, 2011 and 2010, the Bank has drawn down two tranches of $3,016,465 and $1,391,285 with interest rates of 3.679% and 5.175%, respectively. Interest and principal are payable semi-annually until September 10, 2021 (see note 13).

Principal payments for subsequent years ending September 30 and applicable interest due, are as follows:

Year ending September 30,	Principal	Interest	Total
2012	$ 894,760	$ 537,118	$ 1,431,878
2013	921,245	499,909	1,421,154
2014	948,953	462,010	1,410,963
2015	977,887	422,876	1,400,763
2016	1,007,557	383,003	1,390,560
2017 - 2021	5,542,280	1,257,017	6,799,297
2022 - 2025	3,092,958	274,451	3,367,409
	$ 13,385,640	$ 3,836,384	$ 17,222,024

(7) Loans Payable, Continued

Changes in loans payable for the years ended September 30, 2011 and 2010, are as follows:

	Balance October 1, 2010	Additions	Reductions	Balance September 30, 2011	Due Within One Year
Republic of Palau Social Security Retirement Fund	$ 6,000,000	$ -	$ (143,306)	$ 5,856,694	$ 294,062
Mega International Commercial Bank	3,999,553	-	(285,716)	3,713,837	285,716
European Investment Bank	4,117,477	-	(302,368)	3,815,109	314,982
	$ 14,117,030	$ -	$ (731,390)	$ 13,385,640	$ 894,760

	Balance October 1, 2009	Additions	Reductions	Balance September 30, 2010	Due Within One Year
Republic of Palau Social Security Retirement Fund	$ 4,500,000	$ 1,500,000	$ -	$ 6,000,000	$ 200,000
Mega International Commercial Bank	4,285,269	-	(285,716)	3,999,553	285,716
European Investment Bank	4,407,750	-	(290,273)	4,117,477	302,368
	$ 13,193,019	$ 1,500,000	$ (575,989)	$ 14,117,030	$ 788,084

(8) Related Party Transactions

The Bank grants loans to affiliate, officers and employees. Loans made to related parties were extended in the normal course of business and at prevailing interest rates. Loans receivable from officers and employees are $272,932 and $250,055 as of September 30, 2011 and 2010, respectively. Loans receivables from an affiliate amount to $2,925,912 and $3,000,000 as of September 30, 2011 and 2010, respectively. Loans receivable from officers and employees and loans receivable from an affiliate are included within economic development loans receivable in the accompanying statements of net assets.

On November 29, 2010, the Bank and ROP entered into an agreement to assign $820,000 owed to ROP from the PSB Receiver to the Bank, of which the Bank paid $320,000. As of September 30, 2011, the loans receivable from the PSB Receiver is $220,000.

(9) Commitments

Loans Approved

The Bank approved loans aggregating $4,272,004 and $10,756,689 in fiscal year 2011 and 2010, respectively. At September 30, 2011, $4,933,343 was undisbursed. Of the undisbursed loans as of September 30, 2011, $1,818,219 relates to performance bonds on various construction contracts where the Bank acts as insurer.

Leases

On March 20, 2008, the Bank entered into an agreement with the Airai State Public Lands Authority for the lease of land to be used for bank operations and other related business. The term of the lease is fifty years commencing March 20, 2008.

(9) Commitments, Continued

Leases, Continued

Total future minimum lease payments for subsequent years ending September 30, are as follows:

Years ending September 30,	
2012	$ 4,917
2013	4,917
2014	4,917
2015	4,917
2016	4,917
2017 - 2021	24,587
2022 - 2026	24,587
2027 - 2031	24,587
2032 - 2036	24,587
2037 - 2041	24,587
2042 - 2046	24,587
2047 - 2051	24,587
2052 - 2056	24,587
2057 - 2058	7,377
Total future minimum payments	$ 228,658

On May 16, 2008, the Bank entered into an agreement with the Pacific Savings Bank Receiver (PSB Receiver) for the lease of office space. The lease is for three years commencing May 16, 2008. The PSB Receiver prepaid $90,000 representing the entire lease obligation for three years. Total rental income recognized for the years ended September 30, 2011 and 2010 amounted to $17,500 and $30,000, respectively.

Others

In January 2008, the Bank entered into a Memorandum of Understanding (MOU) with the ROP Ministry of Commerce and Trade and the University of Guam - Pacific Islands and Small Business Development Center Network for the purpose of implementing and establishing a Palau Small Business Development Center (Palau SBDC). Under the terms of the MOU, the Bank will provide adequate and expert managerial and administrative supervision to Palau SBDC and handle accounting and recording of all funding activities, disbursement of expenditures, purchases, and related activities of Palau SBDC at no cost.

On May 5, 2008, the Bank entered into an agreement with the International Union for Conservation of Nature and Natural Resources (IUCNNR) for the implementation of the Energy Efficiency Home Loan Project. To enable the completion of the project activities, IUCNNR will provide $500,000 in grant funds to the Bank. The project term is for a period of three years commencing October 5, 2008. As of September 30, 2011 and 2010, due to grantor amounted to $218,869 and $100,689, respectively.

(10) Contingencies

The Bank is authorized to guarantee up to 90% of the principal of loans made by financial institutions to qualified borrowers, in addition to approving direct loans. Eligible principal amounted to $268,705 as of September 30, 2011 of which the Bank was contingently liable for $241,834, and of which $173,510 is with related parties. Of the total loans made by financial institutions, $262,171 is backed by ROP's full faith and credit.

The Bank also guarantees loans made by USDA RD. The Bank has approved guarantees for seventy-seven loans aggregating $3,004,241 at September 30, 2011. Unpaid interest and subsidies related to the loan guarantees as of September 30, 2011 and 2010 amounted to $691,751 and $652,826, respectively, for which the Bank becomes liable once the borrower defaults and a demand notice is issued.

RPPL 5-37 increased the ROP's full faith and credit backing for loans, loan guarantees, and obligations under recourse loan repurchase agreements made by the Bank to $15,000,000. Of this amount, $2,000,000 shall be for residential housing projects and $5,000,000 for the purpose of satisfying requirements for obtaining loans from a bank.

The Bank maintains depository accounts in a non-FDIC insured financial institution. The financial institution went into receivership in November 7, 2006. The Bank's former President was appointed by the Palau Financial Institutions Commission (FIC) as the receiver for the financial institution. Deposits in this financial institution amounted to $205,112 as of September 30, 2011 and 2010 which are collateralized by a third party personal guarantee and an asset of the financial institution. Management is of the opinion that transactions with this financial institution are of similar terms and conditions as with unrelated parties. It is uncertain when the Bank will realize the abovementioned deposits and no provision for potential losses have been made in the accompanying financial statements.

(11) Republic of Palau Civil Service Pension Trust Fund

The Bank contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing multi-employer pension plan established and administered by ROP.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents of ROP, ROP State Governments and ROP agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Normal benefits are of credited total service up to a maximum of thirty years total service. Generally, benefits vest after three years of credited service. Members who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. RPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPL 2-26 at six percent (6%) of total payroll and matched dollar for dollar by the employer. The Bank contributed $23,064, $22,507 and $27,560 to the Fund during the fiscal years 2011, 2010 and 2009, respectively.

Under the provisions of RPPL No. 2-26, the Pension Fund's Board of Trustees adopted a Trust Fund Operation Plan which has the force and effect of law, and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code. The Bank's total payroll for fiscal years 2011 and 2010 was covered in total by the Fund's plan.

(11) Republic of Palau Civil Service Pension Trust Fund, Continued

The Fund utilizes the actuarial cost method termed "aggregate cost method" with actuarial assumptions used to compute the pension benefit obligation as follows: (a) a rate of return of 8.5% per year on the investment of present and future assets, (b) a 3% increase in employee salaries until retirement, and (c) members are assumed to retire at their normal retirement date.

The pension benefit obligation, which is the actuarial present value of credited projected benefits, is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and any step-rate benefits, estimated to be payable in the future as a result of employment service to date. The measure is intended to assist users to evaluate the Fund's funding status on a going-concern basis, and evaluate progress made in accumulating adequate assets to pay benefits when due.

The Fund's October 1, 2009 actuarial valuation determined the unfunded pension benefit obligation as follows:

Active participants	$ 56,060,970
Participants in pay status	47,666,805
Participants with vested deferred benefits	1,779,610
Total pension benefit obligation	105,507,385
Net assets available for benefits, at market value	41,254,319
Unfunded benefit obligation	$ 64,253,066

The actuarial valuation did not provide a breakdown of actuarial present value of vested and non-vested accumulated plan benefits by sponsor or net assets available for benefits by sponsor.

(12) Risk Management

The Bank is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions, injuries to employees; and natural disasters. The Bank has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

(13) Subsequent Events

On December 12, 2011, EIB cancelled the remaining balance of the Bank's credit line of 1,739,427 euros.

On January 5, 2012, the Bank and the PSB Receiver agreed to extend the maturity date of the Bank's loans receivable from November 7, 2011 to November 12, 2012. The PSB receiver will continue to pay installments of $10,000 at the end of each month until the maturity date.

(13) Subsequent Events, Continued

On March 20, 2012, the Bank received a $454,545 grant from the Secretariat of the Pacific Community to fund its Energy Efficiency "Retrofit" Loan Program for existing business and residential buildings.

On May 17, 2012, the Bank entered into a $4,000,000 loan agreement with ROP to finance a loan to the Palau National Communications Corporation for the acquisition of underwater fiber-optic cable for $3,000,000 and for additional Bank lending activities.