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

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2012 AND 2011

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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, 2012 and 2011, 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, the financial statements referred to previously present fairly, in all material respects, the financial position of the National Development Bank of Palau, as of September 30, 2012 and 2011, 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 March 20, 2013, 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 14 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Deloitte & Touche LLC

March 20, 2013

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED SEPTEMBER 30, 2012

This Management's Discussion and Analysis (MD&A) of the National Development Bank of Palau's (the Bank) financial performance and condition for the fiscal year ended 2012 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 Annotated, 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 its own officers to the posts of Chairman, Vice Chairman and Secretary/Treasurer, to serve the length of their terms. One Director's term expired on October 30, 2012 but was later re-confirmed for another three-year term. The Secretary/Treasurer of the Board resigned effective December 29, 2012. The Bank currently has two Director positions vacant. The new ROP administration will be appointing and confirming new members to fill the two vacancies.

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 subjected 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. In 2011, several proposed amendments remained pending in Congress related to control over the Bank's interest rates, terms and restrictions on Bank lending. There were no proposed legislation or amendments in 2012.

The Bank's policies and strategies are implemented through the Bank's President and management. The Bank is organized in three functional areas: Finance, Lending and Risk & Compliance. The Bank operated in fiscal year 2012 for approximately ten months with an Acting President. The new President/Chief Executive Officer (CEO) joined the Bank on August 13, 2012. At a fully-staffed capacity, the Bank has sixteen full-time employees, including the President/CEO.

All Bank operations are conducted from its main office in Ngetkib Village, Airai State. There were no branches, other offices or subsidiaries operating in 2012. Plans for expansion of the Bank's building are set forth in the Bank's ten-year Strategic Plan.

Significant Events in 2012

International Monetary Fund (IMF) Public Information Notice No. 12/24 dated March 14, 2012, states that the Palau economy has recovered strongly from the 2008 and 2009 downturns led by a rebound in tourist arrivals. Real gross domestic product (GDP) growth is expected to be favorable at 3% in fiscal year 2012. Beyond fiscal year 2012, an average annual consolidation of 1.5% of GDP through the rest of the decade is needed to achieve fiscal sustainability. This would require comprehensive tax reform and sizable reductions in the wage bill and subsidies. Annual inflation increased from 1.5% during 2009 and 2010 to 3.5% in 2011 due to a sharp rise in food and fuel prices during the first half of the year.

The economy is likely to continue expanding with growth projected at 3% in fiscal year 2012 and 2% over the medium term. The outlook is clouded by an unsettled global environment and downside risks dominate. A severe downturn in Asia, the main tourist region for Palau, could significantly affect the tourism sector, with large adverse effects on the economy. Although the renewed Compact grants are unlikely to be affected, other aid flows may be delayed as donors face tighter finances. A sharp rise in food and fuel prices could also depress domestic demand and weaken fiscal and external positions, given Palau's heavy dependence on imports. The sizable fiscal deficit and the absence of monetary and exchange rate policies suggest that Palau has limited policy space to counter these risks. The key to a vibrant private sector is complementing the needed fiscal consolidation. Further efforts to promote private sector development are advisable.

Several recent developments indicate a positive growth is very likely for the Palau economy. These include increased airline flights to Palau to support the tourism industry from China Airlines, United Airlines, Japan Airlines, Delta Airlines, Asiana Airlines and the new Palau Airways, an airline based in Palau. Visitors are coming from the Republic of China, Taiwan, Japan, Korea, North America and Europe. Figures released by the Palau Visitor's Authority show that 81,039 visitors came to Palau from January to August 2012. This figure is 12.77% more than the arrivals registered for the same period in 2011 which stood at 71,862. If the current trend holds, Palau could well surpass the 2011 record-breaking figure of more than 105,000 visitor arrivals. This success in 2011 may contribute to securing more stimuli 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 two national policy directions for industry under Palau's leadership are Energy and Agriculture/Aquaculture. The energy policy is characterized by renewable energy support; i.e., National Energy Policy Adoption and various solar systems installed at the National Hospital parking area, the Ministry of Education head office and the airport. As recently as December 7, 2012, per the Island Times, the Senate Joint Resolution to endorse and ratify agreements between ROP and Earth Energy International Co., Ltd. to build solar-powered generators and provide electric power to the islands was adopted. The project is in line with ROP's National Energy Policy. The resolution states that in view of the rising cost of fossil fuel and our National Energy Policy, this investment will be the first of its kind in our region where we have adopted the policy known as Green Energy Micronesia. Continued collaboration between the Energy Office and the Bank in promoting the Energy Loan Programs (ELP) will play a key role in building this industry sector. Currently, the Bank has three ELP subsidy programs as follows:

- Energy Efficiency Subsidy Loan Program (EESP)
- Renewable Energy Subsidy Loan Program (RESP)
- RETRO-Energy Efficiency Subsidy Loan Program (RETRO-EESP)

Agriculture/aquaculture has been an ongoing prominent topic. The agriculture warehouse built in Ngchesar State, the fish hatchery in Malakal (including the coconut buying and planting scheme) and the culturing of sea cucumbers are some of the tangible examples of government policy that has been initiated and are evident in the market.

Growth will likely continue in the sectors of construction and trade as public and private projects continue through 2013; however, a shift more in line with national policy would focus on growth of the agriculture and fishing industries. The Bank has to initiate and take an active role in this area of national policy to promote its underserved sectors of the Palau economy and to diversify credit risks and portfolio concentration.

Private sector projects, namely new hotel projects, hotel renovation, apartment construction, luxury yachts for tourism, farming and fisheries are examples of foreign investment projects that may contribute to the GDP in the near term. These projects will provide increases in hotel room counts to support the tourism industry. Direct industry linkage to large private sector projects will include the farming and fishing industries in support of hotel, food and beverage activities as well as the promotion of similar lines of accommodation in eco-tourism projects. Light manufacturing in terms of local products to be used for these projects would be added growth in the private sector. The Bank will continue to focus on problem loan administration in addition to the Bank's 2012 initiative to grow the underserved areas of the Bank's portfolio such as the agriculture, aquaculture and fishing industries to align the Bank with the Strategic Plan.

The last significant event in 2012 is the implementation of the Secured Transaction Registry (STR) for ROP. All lenders can register all moveable properties (chattel mortgage). The STR makes it easier to grant loans, increases the LTV ratios (i.e. from 30 to 60), and upticks the GDP more than 1%. To preserve priority, lenders need to file notices in the STR to protect their liens against future lenders, buyers or other lien holders.

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 of funds 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 (LOC) 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 with EIB loan covenants resulting from two large accounts that went into arrears with no immediate resolution.

The Bank's BOH LOC 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 LOC is primarily utilized during periods when liquidity is low for funding loans. The Bank has maintained regular payments of the LOC to ensure that at renewal date, it is fully available. Currently, the BOH LOC has a $30,000 balance with available credit of $270,000.

Funding for Operations, Continued

The Bank pursued an additional loan from ROPSSA, the sale of the Bank's housing portfolio and a possible new loan from 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 closed the loan and forwarded all documents to the USDA for review in December 2012. The Bank is required to match these funds in a revolving fund at the signing of the loan and has complied by establishing an account with BOH. The loan funds are to be used to support micro, small and medium sized businesses that have been turned away from other local banks while keeping customer affordability high with low interest rates. Additionally, the Bank continuously works to secure grants 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 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.

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 2012 is 15.32%.

All current guarantees are granted under recourse. The Bank offers 90% loan guarantees to local banks; however, the Bank may also guarantee up to 100% of select home loans from commercial banks made to Palauan citizens. The USDA RD contingent liability is 100%. The total amount for which the Bank was contingently liable in 2012 for commercial banks and USDA RD loans guaranteed by the Bank was $3.5 million. The amended MOU with USDA RD provided the requirements for accounts allowable for reserves and several procedural covenants.

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 is 20% of the Bank's unimpaired paid-in 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. At September 2012, loan maturities remained 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. Further, the Bank is 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.

Direct Loans

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 range from 6% to 10%. Three accounts remain at 12% due to their non-performing status. In 2004, the Bank's Board of Directors lowered the rates between 6% and 10%; however, the non-performing accounts were given two months to bring the accounts current to receive the lower interest rates. The three accounts were not brought current and thus, the interest rates remained at 12%. If these accounts are brought current, an account review will be brought to the Board for approval to lower the interest rates. Rates are considered to include the cost of funds, 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 2012, the Bank approved one hundred thirty-four loan applications. This includes renewals, extensions, performance bonds, cancelled loans and guarantees. Loans approved amounted to $11.7 million with $9.6 million undisbursed at fiscal year end. A majority of the undisbursed loans included sixteen LOCs, guarantee bonding accounts of $4.8 million, a Palau National Communications Corporation loan of $3 million and fifty-four accounts of $1.6 million in the process of disbursement.

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 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 are popular and appear to be successful. Specifically, interest 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 sluggish economy.

Operations, Continued

Direct Loans, Continued

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 term not to exceed five years. The purpose of the 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 are granted for new construction. The Bank has observed more loans being approved under the first-time homeowner program than the standard housing program.

Guaranteed Loans

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 USDA RD Section 502 and 504 housing 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 loan covenants.

Investments

There are 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 took an assignment of an $820,000 note between ROP and the Receivership for Pacific Savings Bank (PSB) 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 were directed and assigned to the Bank. The Bank disbursed $320,000 in 2011 and $500,000 in 2012 for a total of $820,000. The PSB Receiver will continue paying the $10,000 monthly payment until the balance of the note is satisfied.

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 clients on a seven, thirty, sixty and ninety day schedule with the degree of reporting based on each borrower's circumstances. Additionally, Loan Officers conduct account reviews and site visits whenever a weakness becomes evident in a loan. Once a loan is determined to be uncollectible, the loan is placed on a non-accrual status. The Compliance Officer takes over the account and works with the Bank's attorneys to cure, recover or liquidate the collateral.

Operations, Continued

Financial Reporting

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

Overview of Financial Performance

Revenue

The fiscal year 2012 net operating revenues were up 119% from 2011 mainly due to loan payoffs of three facilities of $2.8 million and loan recoveries, specifically, three consolidated facilities of $700,000. Operating revenues include all direct revenues such as interest income and fees on loans, interest on investments (savings accounts with other banks) and other miscellaneous fees (i.e. late charges). Revenue yield increased by 102 points due to large loan payoffs and loan recoveries. There was an increase of lending activity in the housing and fishing sectors and a decrease in the commercial and agriculture sectors. By the end of fiscal year 2012, there was a net of thirty-one charged-off accounts with a payoff balance of $3.6 million. Source funds to be used in 2013 are expected to increase the portfolio to the level planned under the three-year rolling plan.

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.

Loan Interest Rates

The Bank's interest rates remained fixed according to the type of loan funded. Rates ranged from 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 the statutory interest rate of 9% as required by a court-ordered judgment. At the end of fiscal year 2012, the average yield on the Bank's portfolio increased from 8.41% in 2011 to 8.63% as better problem loan management is pursued and due to large loan payoffs. However, loan growth continued in lower interest rate loan programs. At the end of fiscal year 2011, 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.

Grants

In 2011, the Bank implemented the ELP to provide loans to business and housing customers to acquire renewable energy technology. The Bank currently has three grant programs under the ELP.

1. EESP is from the governments of Italy, Austria and the municipality of Milan. The amount of the award is $500,000 and $438,779 has been received as of September 30, 2012. The program expires in May 2013.

Overview of Financial Performance, Continued

Grants, Continued

2. RESP is from the Global Environmental Facility through the United Nations Development Program (UNDP) under the Palau Sustainable Economic Development through Renewable Energy Applications (SEDREA) project. The Bank received on-grid and off-grid solar photovoltaic systems from UNDP through the ROP Energy Office under the SEDREA program. The amount of the award is $400,000 and all funds have been received as of September 30, 2012. As of September 30, 2012, the Bank has inventory of on-grid and off-grid solar photovoltaic systems of $222,347 and $117,227, respectively. The program expired in December 2012.

3. RETRO-EESP is from the North Pacific ACP Renewable Energy and Energy Efficiency Project (North-REP). Funds are from the 10th European Development Fund (EDF-10). The amount of the award is $454,545 and $32,537 has been received as of September 30, 2012. The program expires in April 2014.

Expenses

The Bank's recovery of loan losses and doubtful accounts in 2012 was $704,127 as minimal provisions were made, some large loan facilities were recovered and some large loan facilities were paid-off during the fiscal year. The Bank's net provision for loan losses in 2011 was $976,280. The increase in the provision for loan losses in 2011 was mainly due to additional provisions made for specific large delinquent accounts and 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 additional draws on long-term borrowings to fund lending and low interest rates due to a weakened global economy. Interest expense in 2013 will depend on the cost of future long-term borrowings.

Total operating expenses for 2012 was 20% less than 2011 expenses and 19% less than budget. Savings were realized in professional fees, utilities, training, travel and other expenses. The Bank's commitment for training new and existing staff with internet-based, bank-designed and on-island and off-island training continues each year. No major improvement to the Bank's leasehold was recorded and no new vehicles were procured. The Bank continued to expand its ELP and still has inventory of specially-designed solar photovoltaic equipment which were installed on the Bank's premises in prior years as part of its energy savings policy, demonstration of technology and training of installers. Salaries expense decreased mainly due to the search and appointment of a new President/CEO and a staff member on a leave of absence while furthering his education.

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 456% higher than 2011 resulting largely from large recoveries, large loan payoffs, the Bank's restricted cash and cash equivalents in the reserve and grants received for the Energy Loan Program. Conversely, interest and fee income on loans decreased from 2011. 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

	2012	2011	$ Change	% Change	2010
Revenues:					
Interest income on loans	$ 2,189,974	$ 2,241,902	$ (51,928)	-2%	$ 1,953,169
Loan fees and late charges	81,074	94,990	(13,916)	-15%	66,428
Other	21,005	6,073	14,932	246%	6,412
Total operating revenues	2,292,053	2,342,965	(50,912)	-2%	2,026,009
Provision for loan losses	704,127	(976,280)	1,680,407	-172%	(761,397)
Operating expenses:					
Salaries, wages and fringe benefits	409,101	481,722	(72,621)	-15%	432,754
Rent	2,000	1,000	1,000	100%	10,415
Depreciation	48,223	52,530	(4,307)	-8%	42,366
Training	3,390	25,554	(22,164)	-87%	32,094
Other expenses	241,261	323,096	(81,835)	-25%	335,580
Total operating expenses	703,975	883,902	(179,927)	-20%	853,209
Operating income	2,292,205	482,783	1,809,422	375%	411,403
Total non-operating revenues (expenses), net	(597,869)	(177,819)	(420,050)	236%	(500,217)
Change in net assets	1,694,336	304,964	1,389,372	456%	(88,814)
Net assets at beginning of year	15,913,197	15,608,233	304,964	2%	15,697,047
Net assets at end of year	$ 17,607,533	$ 15,913,197	$ 1,694,336	11%	$ 15,608,233

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

Statements of Cash Flows

	2012	2011	$ Change	% Change	2010
Cash flows from operating activities	$ 1,649,345	$ 1,597,634	$ 51,711	3%	$ 1,194,094
Cash flows from capital and related financing activities	2,363,608	(1,374,963)	3,738,571	-272%	172,692
Cash flows from investing activities	2,866,054	(774,865)	3,640,919	-470%	(2,130,354)
Cash flows from noncapital financing activities	(235,292)	235,044	(470,336)	-200%	333,643
Net decrease in cash and cash equivalents	6,643,715	(317,150)	6,960,865	-2195%	(429,925)
Cash and cash equivalents at beginning of year	954,015	1,271,165	(317,150)	-25%	1,701,090
Cash and cash equivalents at end of year	$ 7,597,730	$ 954,015	$ 6,643,715	696%	$ 1,271,165

The tables above reflect a $4 million loan from ROP, large loan payoffs of $2.8 million and recovery of large loan facilities. The Bank anticipates loan proceeds to be the major funding source in 2013.

Overview of Financial Condition

Loan Portfolio

The Bank approved one hundred thirty-four loans including LOC renewals and amendments, amounting to $11.7 million in 2012 compared to its $5.1 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 2012. The number of applications was steadily received throughout the year following individualized target clients and the Bank's participation in various community events. In 2011, the Bank approved one hundred twenty-six loans including LOC renewals and amendments, amounting to $6.2 million compared to its $4.5 million budget.

Overview of Financial Condition, Continued

Loan Portfolio, 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. Growth in the commercial and agriculture sectors slowed while growth in the housing and fishing sectors slightly increased. The 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. In 2012, three loan facilities were paid-off due to a lack of investor equity to get the project to come to fruition and one loan facility was not funded due to the borrower dealing with his stakeholders. The impact of these commercial loans 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 slightly below 51% of the Bank's portfolio compared to over 56% the year before. Note that Microfinance loans are also included in the housing loan category. Many of these loans were for renovations and improvements to existing dwellings which included the energy efficient programs and subsidy, if qualified. The outstanding loans by sector for 2012 and 2011 are presented in the following table:

	2012			2011		
Sector	**Number**	**Amount**	**%Value**	**Number**	**Amount**	**%Value**
Agriculture	11	$ 141,244	0.58%	13	$ 61,518	0.22%
Fishing	15	72,124	0.30%	11	56,823	0.20%
Commercial	121	12,375,285	50.97%	128	15,605,482	56.30%
Housing	496	11,689,682	48.15%	481	11,995,692	43.28%
	643	$ 24,278,335	100.00%	633	$ 27,719,515	100.00%

The total number of loans on the Bank's books at year end was six hundred forty-three. The Bank did not sell any of its loans/assets in 2012 and no participated loans were made. Negotiations are in progress to sell one of the Bank's loans/assets at the end of 2013. At the end of fiscal year 2011, the total number of loans on the Bank's books was six hundred thirty-three.

Arrears

The total number of accounts with amounts in arrears and notes past maturity (over ninety days) at the end of 2012 was forty-eight accounts amounting to $991,019. The amount of arrears as a percentage of the value of the total outstanding notes at the end of 2012 was 4%. 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 the total outstanding notes at the end of 2011 was close to 2.9%. 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 LOC 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 LOC. See notes 6 and 7 to the financial statements for more information on the Bank's loans payable.

Overview of Financial Condition, Continued

Net Assets

The Bank's overall change in net assets for 2012 and 2011 was $1,694,336 and $304,964 respectively. Net decrease in capital assets for 2012 was $28,833 reflective of no major capital improvements of the Bank's building in Airai. The Bank's overall change in net assets for 2011 and 2010 was $304,964 and ($88,814). Net increase in capital assets for 2011 was $10,220 reflective of additional improvements of the Bank's building in Airai.

Plant and Equipment

At September 30, 2012, 2011 and 2010, the Bank had $709,249, $738,082 and $727,862, respectively, invested in capital assets, net of accumulated depreciation where applicable, including leasehold rights, furniture, fixtures and equipment, vehicles and leasehold improvements, which represents a net decrease in 2012 of $28,833 or 4% over 2011 and net increases in 2011 of $10,220 or 1% over 2010 and in 2010 of $148,140 or 26% over 2009. See note 4 to the financial statements for more information on the Bank's plant and equipment.

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

Statements of Net Assets

	2012	2011	$ Change	% Change	2010
Current and other assets	$ 33,595,054	$ 29,288,972	$ 4,306,082	15%	$ 29,587,138
Capital assets	709,249	738,082	(28,833)	-4%	727,862
Total assets	$ 34,304,303	$ 30,027,054	$ 4,277,249	14%	$ 30,315,000
Loans payable	$ 16,473,959	$ 13,803,832	$ 2,670,127	19%	$ 14,538,223
Other liabilities	222,811	310,025	(87,214)	-28%	168,544
Total liabilities	$ 16,696,770	$ 14,113,857	$ 2,582,913	18%	$ 14,706,767
Net assets:					
Invested in capital assets	$ 709,249	$ 738,082	$ (28,833)	-4%	$ 727,862
Restricted	16,898,284	15,175,115	1,723,169	11%	14,880,371
Total net assets	$ 17,607,533	$ 15,913,197	$ 1,694,336	11%	$ 15,608,233

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.

Risk Management, Continued

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, 2012, twenty-one loans amounting to $2.3 million (payoff balance) were on non-accrual status.

Economic Outlook

Activities of significance planned in 2013 include expansion and sustainability of the Bank's energy loan product on renewable energy and receipt of additional 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 fiscal year is $6.4 million with lending increases in the agriculture and fishing 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, 2011 is set forth in the report on the audit of the Bank's financial statements which is dated September 27, 2012. That Discussion and Analysis explains the major factors impacting the 2011 financial statements. If you have questions about the 2011 or 2010 reports, or need additional information, please contact the Comptroller/Chief Financial Officer at the National Development Bank of Palau at P.O. Box 816, Koror, Republic of Palau 96940, or e-mail sbasilio@ndbp.com or call (680) 587-6327.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Net Assets
September 30, 2012 and 2011

ASSETS	2012	2011
Current assets:		
Cash and cash equivalents	$ 7,597,730	$ 954,015
Restricted time certificates of deposit	452,281	451,300
Receivables:		
Current portion of economic development loans receivable, net	3,425,238	5,511,547
Accrued interest	232,728	305,128
Other receivables, net of allowance for doubtful accounts of $91,602 as of September 30, 2012 and 2011	789,062	398,300
Inventory	356,476	365,865
Prepaid expenses	29,377	37,312
Total current assets	12,882,892	8,023,467
Restricted cash and cash equivalents	716,561	573,431
Time certificates of deposit	201,809	205,112
Economic development loans receivable, net	17,847,668	18,544,071
Property and equipment, net	709,249	738,082
Foreclosed real estate	1,946,124	1,942,891
	$ 34,304,303	$ 30,027,054
LIABILITIES AND NET ASSETS		
Current liabilities:		
Short-term loan payable	$ 30,000	$ 300,000
Current portion of loans payable	3,921,245	894,760
Due to grantor	149,573	218,869
Accounts payable and accrued expenses	73,238	91,156
Interest payable	112,924	118,192
Total current liabilities	4,286,980	1,622,977
Loans payable, net of current portion	12,409,790	12,490,880
Total liabilities	16,696,770	14,113,857
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	709,249	738,082
Restricted	16,898,284	15,175,115
Total net assets	17,607,533	15,913,197
	$ 34,304,303	$ 30,027,054

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2012 and 2011

	2012	2011
Operating revenues:		
Interest income on loans	$ 2,189,974	$ 2,241,902
Loan fees and late charges	81,074	94,990
Other	21,005	6,073
Total operating revenues	2,292,053	2,342,965
Recovery of (provision for) loan losses and doubtful accounts	704,127	(976,280)
Net operating revenues	2,996,180	1,366,685
Operating expenses:		
General and administrative expenses:		
Salaries, wages and fringe benefits	409,101	481,722
Professional fees	54,650	94,446
Depreciation	48,223	52,530
Travel and transportation	36,723	86,926
Dues and subscriptions	28,542	21,030
Repairs and maintenance	23,504	18,247
Supplies, printing, and reproduction	18,973	14,923
Utilities	18,202	20,502
Honorariums and meeting expense	12,979	15,710
Communications	11,275	10,698
Insurance	7,782	8,335
Training	3,390	25,554
Rent	2,000	1,000
Miscellaneous	28,631	32,279
Total general and administrative expenses	703,975	883,902
Operating income	2,292,205	482,783
Nonoperating revenues (expenses), net:		
Grant revenues	106,601	503,219
Interest income on interest bearing accounts	4,623	3,680
Other income	1,019	2,171
Rental income	-	17,500
Interest expense and loan fees	(557,512)	(579,496)
Energy Efficiency Home Loan Project	(104,600)	(100,400)
Gain on sale of property and equipment	-	4,568
Loss on sale of foreclosed real estate	(48,000)	-
Energy Loan Program	-	(29,061)
Total nonoperating revenues (expenses), net	(597,869)	(177,819)
Change in net assets	1,694,336	304,964
Net assets at beginning of year	15,913,197	15,608,233
Net assets at end of year	$ 17,607,533	$ 15,913,197

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Cash Flows
Years Ended September 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	$ 2,364,453	$ 2,453,986
Cash payments to employees for services	(418,844)	(465,793)
Cash payments to suppliers for goods and services	(296,264)	(390,559)
Net cash provided by operating activities	1,649,345	1,597,634
Cash flows from capital and related financing activities:		
Proceeds from issuance of long-term debt	4,000,000	-
Disposal of foreclosed real estate	125,000	-
Acquisition of foreclosed real estate	(128,233)	-
Acquisition of property and equipment	(19,390)	(64,283)
Repayments of long-term debt	(1,054,605)	(731,390)
Interest paid on long-term debt	(559,164)	(579,290)
Net cash provided by (used for) capital and related financing activities	2,363,608	(1,374,963)
Cash flows from investing activities:		
Net change in time certificates of deposit	2,322	(1,780)
Interest received on interest bearing deposits	4,623	3,988
Gain on sale of property and equipment	-	6,101
Net change in restricted cash and cash equivalents	(143,130)	26,635
Loan collections (originations), net	3,002,239	(809,809)
Net cash provided by (used for) investing activities	2,866,054	(774,865)
Cash flows from noncapital financing activities:		
Proceeds from short-term borrowings	-	300,000
Rental income received	-	17,500
Other income received	1,019	2,171
Cash received from grantor	37,305	218,580
Interest paid on short-term borrowings	(3,616)	(3,207)
Repayments of short-term borrowings	(270,000)	(300,000)
Net cash (used for) provided by noncapital financing activities	(235,292)	235,044
Net increase (decrease) in cash and cash equivalents	6,643,715	(317,150)
Cash and cash equivalents at beginning of year	954,015	1,271,165
Cash and cash equivalents at end of year	$ 7,597,730	$ 954,015
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 2,292,205	$ 482,783
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	48,223	52,530
Loss on sale of foreclosed real estate	(48,000)	-
(Recovery of) provision for loan losses and doubtful accounts	(704,127)	976,280
(Increase) decrease in assets:		
Interest receivable	72,400	111,021
Other receivables	(10,762)	(45,160)
Inventory	9,389	970
Prepaid expenses	7,935	(4,091)
Increase (decrease) in liabilities:		
Accounts payable and other liabilities	(17,918)	23,301
Net cash provided by operating activities	$ 1,649,345	$ 1,597,634

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU

Statements of Cash Flows, Continued
Years Ended September 30, 2012 and 2011

	2012	2011
Supplemental schedule of noncash investing activities:		
Foreclosed real estate transferred from loans:		
Increase in foreclosed real estate	$ -	$ 1,575,673
Decrease in economic development loans receivables	-	(1,575,673)
	$ -	$ -
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	$ 104,600	$ 100,400
Increase in Energy Loan Program	-	29,061
Decrease in economic development loans receivables	(104,600)	(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 \$8,842,691 and \$2,005,630 at September 30, 2012 and 2011, respectively. Bank deposits of \$1,536,797 and \$1,004,981 were FDIC insured at September 30, 2012 and 2011, 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 $201,809 and $205,112 as of September 30, 2012 and 2011, respectively. 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 $50,143 and $50,047 of cash and cash equivalents as of September 30, 2012 and 2011, respectively, 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 $523,645 and $523,384 as of September 30, 2012 and 2011, respectively. Additionally, $142,773 and $-0- of cash received from grantor agencies was restricted at September 30, 2012 and 2011, 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. Inventory of on-grid and off-grid solar photovoltaic systems amounted to $348,548 and $357,464 as of September 30, 2012 and 2011, respectively.

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 $2,297,307 and $3,725,356 at September 30, 2012 and 2011, 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, 2012 and 2011, 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, 2012 and 2011.

I. New Accounting Standards

During the year ended September 30, 2012, the Bank implemented the following pronouncements:

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

- GASB 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 the frequency and timing of measurements for actuarial valuations first used to report funded status information in OPEB plan financial statements. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

- GASB 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 implementation of this pronouncement did not have a material effect on the accompanying financial statements.

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 has not yet determined the effect of implementation of this statement on the financial statements of the Bank.

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities,* which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of the Bank.

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of the Bank.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions,* which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements 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, 2012 and 2011, 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, 2012 and 2011 are as follows:

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

	2012	2011
Loans receivable	$ 24,115,901	$ 27,719,515
Less:		
Allowance for loan losses	(2,631,908)	(3,467,562)
Deferred loan origination fees	(211,087)	(196,335)
	21,272,906	24,055,618
Current portion of economic development loans receivable	(3,425,238)	(5,511,547)
	$ 17,847,668	$ 18,544,071

Maturities of the above principal balances subsequent to September 30, 2012, will be as follows:

Fully matured and others	$ -
1 - 6 months	949,740
7 - 18 months	480,255
19 months - 3 years	602,363
After 3 years	22,083,543
	$ 24,115,901

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

	2012	2011
Balance - beginning of year	$ 3,467,562	$ 2,431,451
Recoveries of loan previously charged-off	91,717	234,977
(Recovery) provision for loan losses	(704,127)	884,678
Loans charged-off	(223,244)	(83,544)
Balance - end of year	$ 2,631,908	$ 3,467,562

(4) Plant and Equipment

A summary of plant and equipment as of September 30, 2012 and 2011, is as follows:

	Estimated Useful Lives	Balance at October 1, 2011	Additions	Deletions	Balance at September 30, 2012
Depreciable assets:					
Leasehold rights	39 - 50 years	$ 493,206	$ -	$ -	$ 493,206
Leasehold improvement	5 years	249,774	2,648	-	252,422
Furniture, fixtures and equipment	2 - 20 years	199,763	16,742	-	216,505
Vehicles	5 years	74,459	-	-	74,459
		1,017,202	19,390	-	1,036,592
Less accumulated depreciation		(279,120)	(48,223)	-	(327,343)
		$ 738,082	$ (28,833)	$ -	$ 709,249

(4) Plant and Equipment, Continued

	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
Leasehold improvement	5 years	225,880	23,894	-	249,774
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
		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

(5) Foreclosed Real Estate

A summary of the changes in foreclosed real estate as of September 30, 2012 and 2011 is as follows:

	2012	2011
Balance at beginning of year	$ 1,942,891	$ 367,218
Additions	128,233	1,575,673
Disposals	(125,000)	-
Balance at end of year	$ 1,946,124	$ 1,942,891

Title to foreclosed real estate of $1,915,490 and $1,915,891 is in the Bank's name as of September 30, 2012 and 2011, 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% (1.65% and 1.75% at September 30, 2012 and 2011, respectively). The credit line is collateralized by an assignment of $452,281 and $451,300 in TCDs as of September 30, 2012 and 2011, respectively.

Changes in short-term loans payable for the years ended September 30, 2012 and 2011, are as follows:

	Balance October 1, 2011	Additions	Reductions	Balance September 30, 2012	Due Within One Year
Short-term loans payable	$ 300,000	$ -	$ (270,000)	$ 30,000	$ 30,000

(6) Short-Term Loans Payable, Continued

	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

(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.

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 $5,563,337 and $5,856,694 with interest at 4.5% as of September 30, 2012 and 2011, 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, 2012 and 2011, the Bank has drawn down two tranches of $1,391,285 and $3,016,465 with interest rates of 5.175% and 3.679%, respectively. Interest and principal are payable semi-annually until September 10, 2021. On December 12, 2011, EIB cancelled the remaining balance of the Bank's credit line of 1,739,427 euros.

(7) Loans Payable, Continued

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 (PNCC) for the acquisition of underwater fiber-optic cable for $3,000,000 and for additional Bank lending activities. The note is uncollateralized and is due and payable 120 months after the loan date, with interest fixed at 2.0% per annum, payable in monthly installments. Interest and principal is payable monthly and commences thirty-six months after the advance of proceeds over the remaining period of the loan term. Any principal payment received from PNCC within the first 36 months will be paid by the Bank to ROP on the 5th business day of the first month after the first 36-month period. On March 18, 2013, the Bank received a letter from PNCC stating that PNCC will not be able to activate the loan earmarked for $3,000,000. ROP requested the Bank to return the $3,000,000. The loans payable of $3,000,000 is classified as current portion at September 30, 2012.

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

Year ending September 30,	Principal	Interest	Total
2013	$ 3,921,245	$ 559,689	$ 4,480,934
2014	948,953	482,010	1,430,963
2015	1,001,697	442,856	1,444,553
2016	1,150,414	401,264	1,551,678
2017	1,182,490	356,057	1,538,547
2018 - 2022	5,776,648	1,065,689	6,842,337
2023 - 2025	2,349,588	159,026	2,508,614
	$ 16,331,035	$ 3,466,591	$ 19,797,626

Changes in loans payable for the years ended September 30, 2012 and 2011, are as follows:

	Balance October 1, 2011	Additions	Reductions	Balance September 30, 2012	Due Within One Year
Republic of Palau Social Security Retirement Fund	$ 5,856,694	$ -	$ (293,357)	$ 5,563,337	$ 307,393
ROP Government	-	4,000,000	-	4,000,000	3,000,000
Mega International Commercial Bank	3,713,837	-	(285,716)	3,428,121	285,716
European Investment Bank	3,815,109	-	(475,532)	3,339,577	328,136
	$ 13,385,640	$ 4,000,000	$ (1,054,605)	$ 16,331,035	$ 3,921,245

	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

(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 $360,682 and $272,932 as of September 30, 2012 and 2011, respectively. Loans receivables from an affiliate amount to $2,808,355 and $2,925,912 as of September 30, 2012 and 2011, 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, and the Bank paid ROP $320,000. 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. The Bank paid ROP the remaining balance of $500,000 in August 2012. As of September 30, 2012 and 2011, the loans receivable from the PSB Receiver is $600,000 and $220,000, respectively.

(9) Commitments

Loans Approved

The Bank approved loans aggregating $7,377,559 and $4,272,004 in fiscal years 2012 and 2011, respectively. At September 30, 2012, $9,670,181 was undisbursed. Of the undisbursed loans as of September 30, 2012, $513,886 relates to performance bonds on various construction contracts where the Bank acts as insurer. At September 30, 2012, no performance bonds have been called.

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.

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

Years ending September 30,	
2013	$ 4,917
2014	4,917
2015	4,917
2016	4,917
2017	4,917
2018 - 2022	24,587
2023 - 2027	24,587
2028 - 2032	24,587
2033 - 2037	24,587
2038 - 2042	24,587
2043 - 2047	24,587
2048 - 2052	24,587
2053 - 2057	24,587
2058	2,459
Total future minimum payments	$ 223,740

(9) Commitments, Continued

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.

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.

(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 $207,882 as of September 30, 2012 of which the Bank was contingently liable for $187,094 and of which $134,914 is with related parties. Of the total loans made by financial institutions, $202,249 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-six loans aggregating $3,267,217 at September 30, 2012. Unpaid interest and subsidies related to the loan guarantees as of September 30, 2012 and 2011 amounted to $701,671 and $691,751, 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 $201,809 and $205,112 as of September 30, 2012 and 2011, respectively, 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 $24,710, $23,064 and $22,507 to the Fund during the fiscal years 2012, 2011 and 2010, 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 2012 and 2011 was covered in total by the Fund's plan.

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.