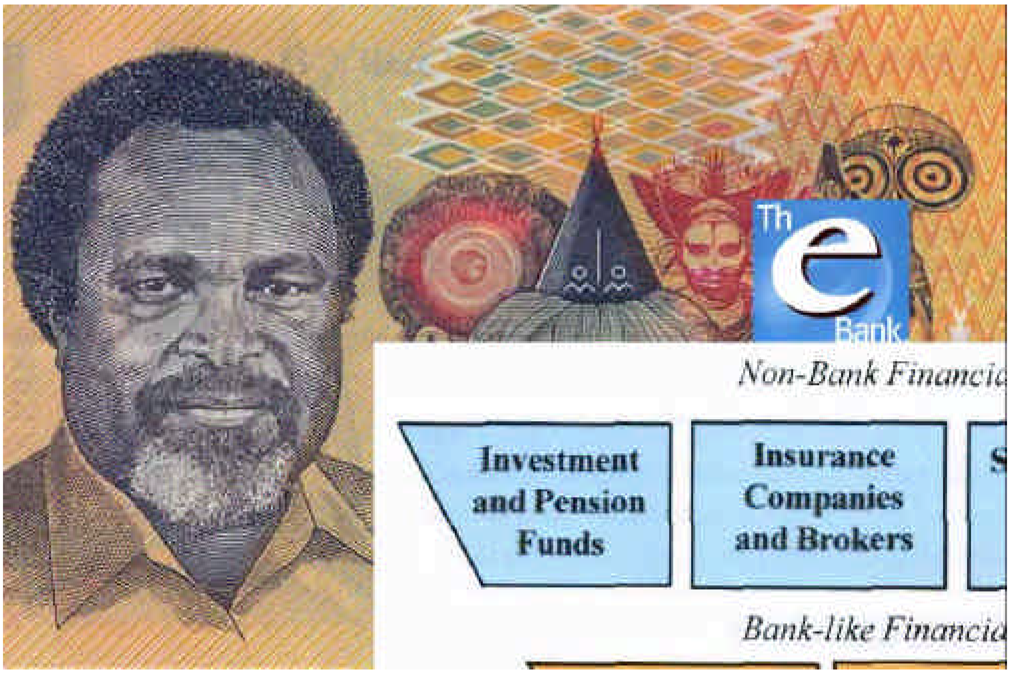
Social and Spiritual Development Strand
Social Science

Unit 5: Economic Development

Module 5.4: The Finance Industry



Student Support Material

Acknowledgements

Materials written and compiled by Sue Lauer (PASTEP adviser).

Layout and diagrams supported by Nick Lauer.

Date: 5 July 2002

PASTEP

Primary and Secondary Teacher Education Project

Australian Agency for International Development (AusAID)
GRM International

Papua New Guinea-Australia Development Cooperation Program

Unit outline

Unit	#	Modules
Unit 5 **Economic Development**	**5.1**	**Managing the Economy (Core)**
	5.2	**Trade and Development (Core)**
	5.3	**Employment and Production (Optional)**
	5.4	**The Finance Industry (Optional)**

Icons

🕮	Read	or	research
✍	Write	or	summarise
☞	Activity	or	discussion

Table of contents

Module 5.4: The Finance Industry

Rationale

Finance is the most prominent and powerful force linking different parts of the world economy, and financial transactions worldwide are far larger than movements of products. While Papua New Guinea's financial system appears simple in relation to financial systems worldwide, it provides appropriate domestic and international banking and financial services for its level of development. Knowledge of the finance industry is needed in order to understand the forces that influence economic and social development

Objectives

At the completion of this module students should have acquired knowledge and understanding about:

- The interrelationships between countries, markets and financial systems
- Financial concepts such as exchange rates, price fluctuation
- The impact of internal and external factors on finance and economic systems
- The use and nature of credit facilities
- Public and personal insurance systems

Section 1 - Financial Systems

Topic 1 - Finance

Finance is the most prominent and powerful force linking different parts of the world economy because financial flows are far larger than movements of products. The simplest form of international financial business, buying and selling foreign exchange, is estimated to equal a trillion US dollars daily. That is very much greater than the volume of transactions generated by importers and exporters.

The majority of financial transactions represent banks, corporations, and individuals switching financial assets from one country's currency to another in response to movements in actual and expected interest rates on different currencies and their exchange rates. In moving between currencies, investors buy and sell bank deposits, treasury bills, and other short-term securities, bonds, and shares in different countries, as well as non-financial assets such as real estate. Consequently, there is a tendency for interest rates or the prices of securities, bonds, and shares in one country to be affected by interest rates and financial prices in others. Instead of a country's interest rates being wholly determined by its own conditions, they are the outcome of world forces.

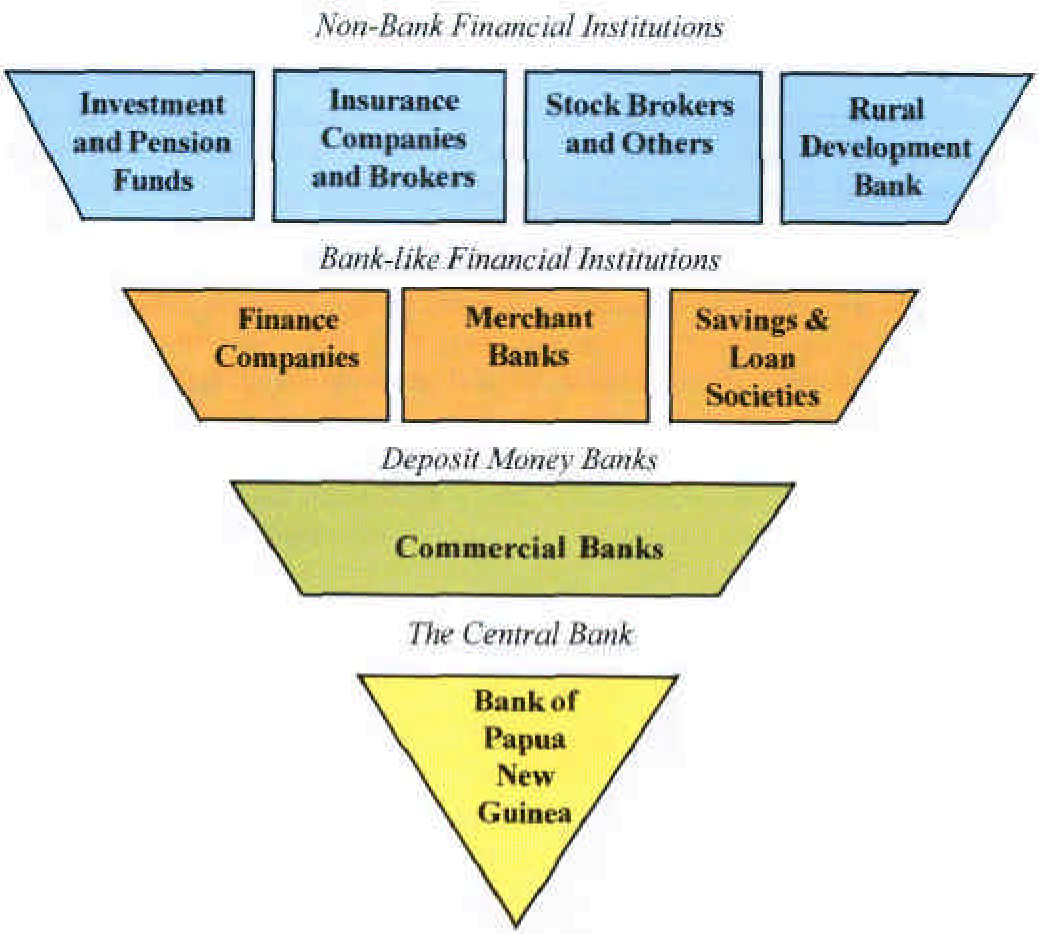
The creation of a world market in finance since the early 1970s has meant, in some cases, that extreme fluctuations in one financial centre have been mirrored in others, emphasising the worldwide character of finance. Black Monday, the crash of the New York stock market in October 1987, was echoed in stock markets around the world, and, on a smaller scale, the sharp price falls on the Mexican stock market in early 1995 led to falling prices on "emerging markets" elsewhere in Latin America and in Asia.

Papua New Guinea's financial system is domestically oriented and dominated by traditional savings instruments and investment activities. It has experienced a sufficient degree of financial deepening since monetary independence to facilitate the adoption of a market oriented monetary management regime. Since 1980, when the treasury bill auctions were first introduced, the Bank of Papua New Guinea has continually sought to refine its monetary policy in keeping with world trends.

During the 1980's, the Central Bank encountered difficulties in pursuing rigid monetary targets and in managing periods of fluctuating bank liquidity. These difficulties were best illustrated by the unprecedented rise in interest rates between 1985 and 1986, which occurred against a background of economic stability and a strong external sector.

Controlling private sector credit was the principal concern of monetary policy until 1990. In the early 1990's, the combination of an expansionary fiscal policy, accommodative monetary policy and the deregulation of financial markets proved unsustainable. External stability was lost, forcing the government to abandon its commitment to a fixed exchange rate. Monetary policy since the float of the kina remains has been influenced by an increased level of government domestic debt.

While Papua New Guinea's financial system appears simple in relation to financial systems worldwide, it does provide the necessary domestic and international banking services for its level of development.



Financial institutions in PNG (from: Banking & Money in PNG)

The size of the financial market has an impact on the activities of financial institutions. A small market limits the number of participants. The lack of competition inhibits the development of inter-bank and short-term money markets and reduces the incentives for innovation. The domestic financial system has however evolved considerably since 1973. It has undergone widespread structural changes brought about by the changes in the real economy, the financial environment and technological advances. There have been many noteworthy innovations in the nature of financial instruments, bank and financial institution operations and approaches to liquidity and risk management.

Papua New Guinea remains a high cost environment for financial services with the performance of the financial sector restricted by the same factors which inhibit investment and growth in the non-mineral private sector. In relation to the agricultural sector, the rugged terrain of the highlands and inaccessibility of the remoter parts of the country mean that the costs of evaluating proposals and of monitoring and supervising credit will continue to remain high.

In the 1960's and 1970's, development banks and state ownership in the commercial banking system were common characteristics of a number of developing economies. An emphasis on subsidised credit provision with low interest rates, as a means of encouraging investment, was also a common element of financial market strategies in both developing and industrialised countries.

In Papua New Guinea, the corporatisation and eventual privatisation of state owned financial institutions is in line with trends worldwide. Government intervention, which until the late 1980's centred on ownership and control of institutions, should therefore become more benign and geared towards regulation and supervision. In this way, the government can help maintain a sound, competitive and diverse financial system encouraging commercial activity, raising savings and investment levels and increasing efficiency in the allocation of scarce resources. However, large government deficits can affect stability, the price of financial services, the behaviour of investors and savers and can ultimately retard the development of a free, efficient financial system.

An important lesson from Papua New Guinea's experience since independence is that structural or functional changes alone can do little to change savings habits or increase credit demand. In many rural communities, traditional values to material possessions, centred on communal ownership and distribution, are still prevalent and outweigh the western ethic of accumulation.

Foreign aid and government fiscal policy have often been emphasised as the main means of increasing capital formation in developing countries. In Papua New Guinea, a significant portion of government expenditure is devoted to recurrent expenditures and the government's allocation of its resources has not always been efficient and determined by non-economic factors. Insurance and Pension Funds are important sources of investment funds and the government needs to adopt a more commercial approach to the management of its financial assets.

The lack of supervision and poor investment decisions have been two of the main issues raised in relation to the activities of the superannuation funds, insurance companies and Investment Corporation during the 1990's. For the superannuation funds, the importance of protecting the welfare of their members and investors should govern their investment decisions, not profit maximisation.

☞ 5.4 Activity 1

Study the financial section of a daily newspaper and list the range of topics covered in the articles.

In the same section of the newspaper, identify the regular columns. What information do they provide?

Topic 2 - Banking and financial services

The **Banks and Financial Institutions Act 2000** is the governing legislation in the licensing and regulation of banks and licensed financial institutions. The license to carry on banking business as either a bank or a Licensed Financial Institution is granted by the Central Bank in writing, should all criteria be met as specified by the Central Bank in accordance with the Banks and Financial Institutions Act 2000. The criteria include plan of operations, names and curriculum vitae of shareholder controllers, indirect controllers, directors, chief executives and managers, and management structure and operations details. There is a minimum capital requirement of K15, 000,000 in net assets for a Bank and K1, 500,000.00 for a Licensed Financial Institution. Application fees for a Bank are K25, 000 and K15, 000 for Licensed Financial Institutions. The corresponding amounts are due for the License fee itself and for annual renewal.

Current trading banks in Papua New Guinea are:

- Australia and New Zealand Banking Group (PNG) Limited (ANZ)
- Bank of South Pacific Limited (BSP)
- Maybank (PNG) Limited
- Papua New Guinea Banking Corporation (PNGBC) and
- Westpac Bank (PNG) Limited

Registered financial companies within the country include:

- AGC (Pacific) Limited Papua New Guinea
- Credit Corporation (PNG) Limited
- Finance Corporation Limited
- First Investment Finance Limited
- Kina Finance Limited and
- Pacific Capital Limited

In PNG the business of raising capital through bonds and shares issues and the trading of these securities is still developing. Due to the high cost of living, the average Papua New Guinean tends to spend more and save less. For the last 10 years statistics show that if someone is paid K100 per fortnight s/he spends at least K70.00 and saves only K30.00 or less.

The scarcity of "spare money" is reflected in the willingness of the government to offer high interest rates for its short-term securities unlike those seen in Australia or anywhere else. This is also reflected in the high IBD rates and term deposits interest offered by domestic commercial banks and financial institutions for relatively small deposits compared to overseas money markets.

The disadvantage is that because savings are essential for investments, the lack of sufficient savings to facilitate investments limits the depth and liquidity PNG's financial market. Nevertheless a very positive initiative has been taken to encourage and provide more investment options through the establishment of the Port Moresby Stock Exchange (POMSoX).

☞ 5.4 Activity 2

Which of the banks and financial institutions listed above have branches in your closest town?

Which institution appears to have the most customers? Why do you think this is the case?

Where do you or members of your family bank? Why?

Topic 3 - The money market

The Port Moresby Stock Exchange (POMSoX)

POMSoX was officially launched on 28 April 1999 operating much like the Australian Stock Exchange (ASX), using the ASX Business and Listing Rules. The Port Moresby Stock Exchange is Papua New Guinea's national stock exchange with a listing of nine companies. These companies include Credit Corporation, Cue Energy, Highlands Pacific, InterOil Corporation, Lihir Gold, Mosaic Oil, Orogen Minerals, Oil Search Limited and Steamships. Eight of the nine companies are also listed on the Australian Stock Exchange with Credit Corporation the exception.

POMSoX is open to the public but those wishing to invest must go through a stockbroker who is a member of the stock exchange. Currently there are two registered stockbrokers who are members of the stock exchange. The two brokers are Kina Securities Limited and Capital Stockbrokers. POMSoX currently offers a comparatively attractive option to the Australian Stock Exchange in that there is no stamp duty, VAT or capital gains tax charge on buy and sell transactions. Your purchase and sale proceeds are tax-free and you only have to worry about the commission for your broker, which is usually only about 1-2% of the total value of the transaction. Furthermore, transaction costs for the same stocks listed on ASX are cheaper on POMSoX due to the value of the kina against the Australian Dollar.

For privatisation, POMSoX will provide a medium by which ordinary Papua New Guineans will become shareholders and decision makers in government businesses as well as increase management and board accountability to shareholders plus other stakeholders.

☞ 5.4 Activity 3

Divide into small groups and each group write a brief description of one of the nine companies listed on POMSoX. Find out what the company share price is and a week later check the price again. Has it changed? How much would you have made or lost on an investment of 1000 shares?

Current interest rates

The current downward trend in interest rates has reduced income and hopes of sustaining a living based on fixed income investments. Moves to intervene and save the currency from falling further have a direct bearing on interest rates.

A shift in government borrowing policy and international credit ratings affects domestic interest rates. Increases in international credit ratings encourage foreign borrowing and therefore reduce the potential for the government to affect the domestic rate of borrowing. On the other hand, a deteriorating PNG international credit ratings encourage internal borrowing because it becomes increasingly difficult for the country to seek funds internationally.

☞ 5.4 Activity 4

Form one group for each of the main banks or financial institutions in your nearest town and investigate the following

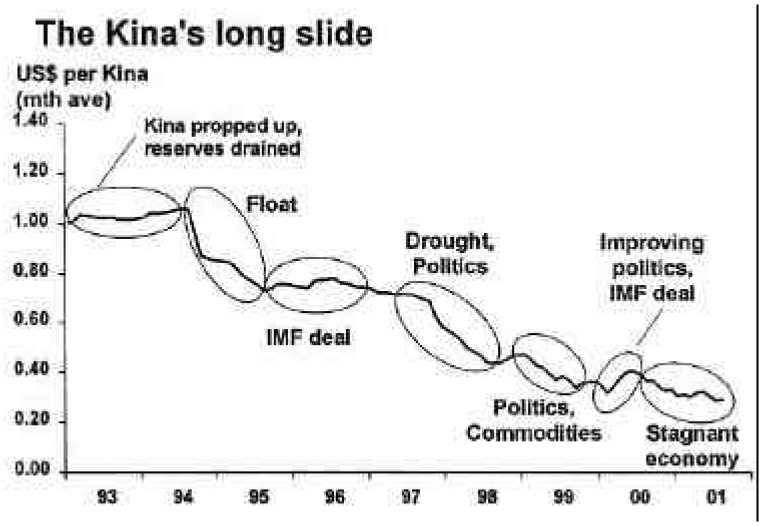
1. Different types of savings and investment accounts available
2. Interest rate payable on each account

Which bank or institution offers the best interest rate on your savings?

Exchange rates

The exchange rate is the price at which one currency can be converted into another or into gold or other medium of international exchange. The spot price is the one that exists for immediate transactions. A forward price is one that is fixed between buyer and seller for a transaction that is to take place at a specified time in the future. Suppose a Papua New Guinean company is buying machinery from Germany for a price of DM 1 million, with payment to be made on delivery in three months' time. By the time those three months are up, the kina/deutschmark exchange rate is likely to have changed. If the kina has depreciated in value by 5 per cent, the cost of the machinery will have effectively increased by the same amount unless the company has protected itself from the uncertainties of shifts in exchange rates by taking out a forward-price currency contract when it agreed to the deal to buy the machinery.

There are a number of ways in which countries manage their exchange rates. When a currency is floating, its exchange rate is set by the market. The more in demand a currency is, the higher its price (exchange rate) will be. Sometimes a central bank will intervene in the market to help achieve a specific price level for its country's currency; this is known as “dirty floating”. At the beginning of the 1990s, less than one-fifth of the world's 150 or so main currencies were freely floating. By 1993, following the shake up in the former Communist world, some 50 of the world's currencies were freely floating.



Falling value of the Kina (Source: ANZ Bank)

☞ 5.4 Activity 5

Study the diagram above. Describe the impact of the IMF and politics on the value of the kina.

Find copies of five old newspapers and one or two recent newspapers. Create a table showing the changing value of the kina against the Australian dollar, US dollar, Euro, and Japanese Yen. What has happened to the kina? Why? Against which currency has it changed the least? Why?

When a currency is fixed, its exchange rate is pegged at a certain level, which may be raised (revalued) or lowered (devalued) from time to time. A fixed currency may in fact be fixed within a narrow band, as was the case under the agreement reached at the Bretton Woods Conference that governed the exchange rates of all members of the International Monetary Fund (IMF) for almost three decades after World War II. Fixed currencies are usually fixed in relation to another currency (often the United States dollar or, in West Africa, the French franc).

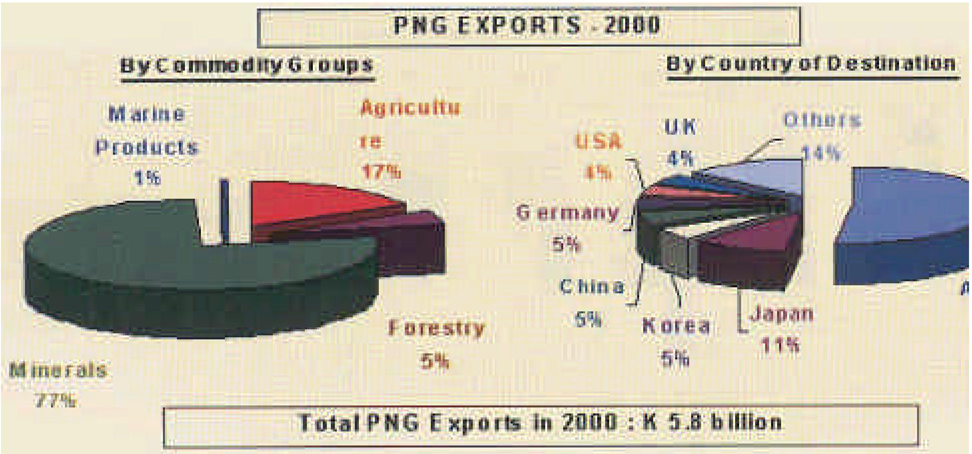
Financial indices

Other financial indices produced include those that monitor sectors, such as tobacco, transport, utilities, media, leisure and hotels, food retailers, general retailers, and extractive industries. This allows investors to compare the performance of different sectors and to compare companies within a sector.

The complexity of financial markets is such that financial indices help provide an overall picture of how a market is performing and a yardstick that enables investors to compare the performance of a security with the performance of the index. If an investment fund has grown by more than a particular index, it could be said that the fund manager has performed better than average.

Although the role of financial indices is to help those trading on the financial markets, they are also important economic indicators as they reveal confidence and market expectations in different sectors as well as overall.

Foreign exchange is a commodity, and its price fluctuates in accordance with supply and demand so exchange rates are published daily in the principal newspapers of the world. The exchange rate can be used as a means of increasing the returns to producers and exporters. World market prices, the exchange rate and domestic factors such as transport costs influence the prices received by growers. By increasing the cost of imports, a devaluation can provide an incentive to increase the supply of food crops to the domestic, and potentially, to overseas markets.



Factors affecting the exchange rate (Source: PNG year Book 2001)

Section 2 - Credit systems

Topic 4 - Electronic payments

Technology is resulting in a shift away from making cash payments to an increasing use of plastic charge cards. The era of cashless shopping began with the introduction of nationally operating Electronic Funds Transfer at Point Of Sale network (EFTPOS). This gives consumers the ability to buy goods electronically at participating retail groups throughout the country. Banking is also commonly done through machines – known as ATMs (Automatic Teller machines)

Automatic teller machine

Charge cards

Charge cards such as Bankcard, Visa, Mastercard, Keycard, Access cards and Savecard are used to pay for goods and services. However, the way that they are used differs. To understand the most important difference you need to understand that:

- Some are credit cards
- Some are debit cards
- Some are both credit and debit cards

Credits cards allow customers to pay for goods and services with money lent to them by a financial institution, usually a bank, but perhaps a building society or credit union. For our purposes, a financial institution is an organisation which takes deposits from savers and lends them to people who want to borrow money.

Debit cards allow customers to pay for goods and services by drawing on their own money which they have in an account at a bank or other financial institution.

Here's how they work

Assume that you have K200 in your bank account on 1 April. The bank has issued you with both a debit card and a credit card.

On 1 April you buy clothes for K50. That is the only transaction (ie the only time that you use your account) on 1 April.

If you pay for the clothes with your credit card, you will have K200 in your account at the end of the day on 1 April. You pay with the credit card: the bank lends you K50.00; and the bank pays The Store for you.

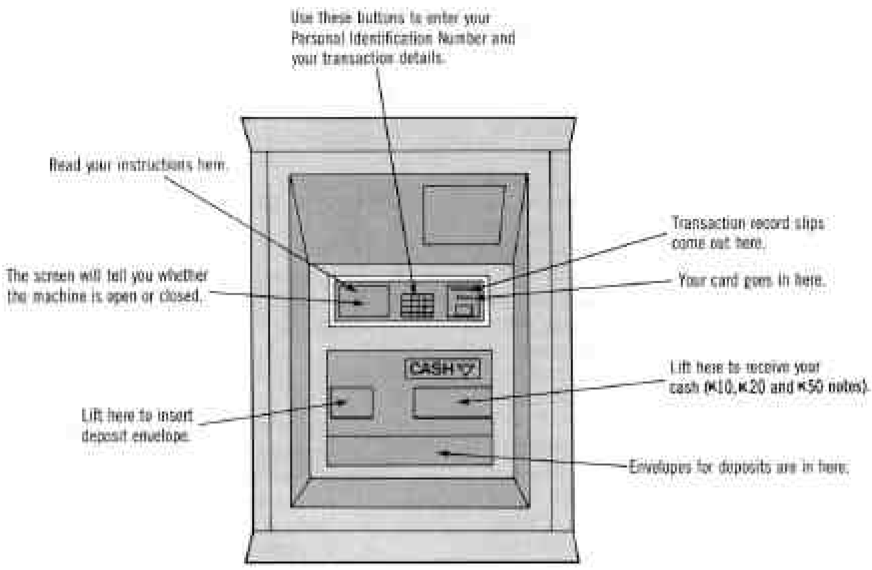
If you pay for the clothes with your debit card, you will have K150 (ie K200-K50) in your bank account at the end of the day on 1 April.

Credit cards

Credit cards are popular because they allow people to buy now and pay later. They are convenient. Consumers do not have to carry large amounts of cash. Consumers can take advantage of bargains which they may not be able to do if they relied on carrying cash. They provide continuing credit. Cardholders can spend up to the limit allocated to them, make some repayments and then spend up to that limit again. They don't have to enter into a new credit arrangement each time they want credit.

With any of the cards, you may have to pay interest on the goods and services which you buy. The credit card companies generally give you an interest-free period in which to pay back the money which they lend you to buy your goods and services. If you don't pay within that period, they charge a fee for lending you the money. That fee is called a credit charge or interest.

A credit card can be used to pay for goods and services at any store which displays the credit card symbol. It can often be used when buying by phone or mail. It can also be used to borrow cash from the banks which are involved in the Bankcard scheme. When the bank lends you cash, it is said to be making a cash advance.



How an ATM works

☞ 5.4 Activity 6

Visit a local bank and find out the rules governing the application for and use of credit cards

What is the difference (if any) between a Kundu card, Savecard and Accesscard?

When did credit cards and debit cards first appear in PNG?

Survey 50 people at your college to find out who has a credit or debit card and how long they have had them

Your signature on a bankcard is used as proof that you are the owner of the account when you use your card. When you buy goods with your card, you will be asked to sign a docket. You should keep the docket as a receipt. Banks send you a statement at regular intervals (once each month). The statement lists all of the goods and services you have bought with your card during the month. It will also show any goods which you have returned and for which you have received a refund (a credit), any cash advances which you have made and interest and other charges that have accrued. You should check your receipts against the purchases listed on the statement.

Using credit cards wisely

Credit cards provide a very convenient means of buying now and paying later. Their convenience can be both a plus and a minus for cardholders. Having a credit card in your pocket can encourage you to buy on impulse. You might buy things which you don't really need and you can't really afford. If you are not careful, you can over-commit yourself and owe money for not only the goods and services which you have bought but for interest that has been charged. Credit cards need to be used wisely. Every year there are many people who can't repay the amounts that they have spent on their credit cards.

Debit cards

Debit cards appeared in Australia in the early 1980s when Automatic Teller Machines (ATMs) were introduced. Bank, building society and credit union customers could use their ATM cards to withdraw money from their accounts.

Electronic Funds Transfer at the Point of Sale (EFTPOS)

EFTPOS is an electronic payments system, ie money is transferred by computer from one account to another. It allows customers to use either their debit card or their credit card to pay for goods and services at stores which have an EFTPOS terminal. EFT means that money is transferred electronically by computer. POS means that it is transferred when the consumer buys a good or service. The EFTPOS machine in the shop performs the tasks of a cash register, as well as assisting the transfer of funds between accounts. It has an electronic pad attached to it. The electronic pad is used by the consumer for debit transactions. The consumer uses the electronic pad to key in their personal identification number (PIN). This number is allocated to the cardholder when the card is issued so that they alone can authorise use of the account. It is usually a four-digit number. The cardholder needs to memorise the number and ensure that no one else is able to find out what it is.

☞ 5.4 Activity 7

Divide into groups and survey as many shops as possible in your closest town. How many of the shops have EFTPOS so customers can pay using their cards.

Name or classify the stores you visited. Do only large stores or particular types of stores have EFTPOS systems?

Here's how EFTPOS works with a debit card

The consumer hands their card to the shop assistant.

The shop assistant runs the card through the card reader. The card has account information encoded in a magnetic stripe. It will include the account number, the type of account and the account balance.

The shop assistant enters the amount of the purchases.

The shop assistant gives the consumer the electronic pad. The consumer keys in their personal identification number (PIN). It authorises use of the account.

The customer enters whether they want the money taken from their cheque or savings account.

If there is sufficient money in the account, the Pin pad will say 'OK'. The balance in the consumer's account is reduced and the balance in the shop's account is increased.

The machine issues a receipt for the customer.

Consumers can also withdraw cash from their accounts at EFTPOS terminals, at the discretion of the store. This facility is called 'cash back'.

Benefits of EFT for the consumer

The benefit of EFT for consumers is the ability to pay from a number of different deposit accounts such as savings or cheque accounts. In the case of cheque accounts, the customer need not write a cheque.

- Reduction in the number of visits to a bank or building society
- Ability to access accounts and receive cash when paying for goods and services
- Ability to leave money securely in the bank, building society or credit union account until it is required

One of the concerns of consumers when new technology like the EFTPOS system is introduced is that they are not sure of their rights and obligations in using the system. One concern with EFT is that cards may be lost and unauthorised purchases may be made with them. Another concern has related to the rights of the consumer should an error occur as the result of a malfunction in the EFT system. In the early stages of EFTPOS, many consumers experienced problems which were not resolved satisfactorily. The finance industry responded by developing a code of conduct to ensure that customers, retailers and the finance industry were fairly treated by EFTPOS.

☞ 5.4 Activity 8

What other plastic cards are in use eg phone cards in PNG?

Explain how they work.

Topic 5 - Other ways of paying for goods and services

Direct entries

People who are required to make regular payments for fixed amounts can arrange with their financial institution to make the payment direct and take the amount from their account balance, ie debit their account. Housing loan repayments, personal loan instalments and insurance premiums are examples of regular payments.

Cheques

A cheque is a paper form instructing a transfer of funds (money) from one person to another. Until the acceptance of bankcards, cheques were the only widely accepted way of making a non-cash payment. As plastic cards are used more and more widely, the use of cheques may decrease although bankers think that they will remain an important means of payment for many years yet.

Cheques are sometimes used to pay for products in shops. They are more commonly used to pay bills, such as electricity and gas, which are sent through the mail. Cheque services are supplied by banks. To write a cheque, you need to have a cheque account with a bank or with another financial institution (eg a building society or credit union) which has links with a bank. The cheque instructs your bank to pay an amount of money to the person or organisation to which you owe money.

A cheque is an order from the drawer (the person or business who has the cheque account) to the drawee (the drawer's bank) instructing the drawee to take some money out of the drawer's account and give it to the payee (the person receiving the payment). Note that:

- The amount of money to be paid is written in words and numerals. This ensures that the bank pays the correct amount.
- Not negotiable is written across the cheque between two parallel lines. The lines mean that the cheque has to be paid into a bank account. 'Not negotiable' ensures that the only person who can receive money from the cheque is the payee.

Money order

Money can be paid to a specific person by money order. Money orders can be bought at any post office or post office agency to allow customers to transfer amounts up to K1000. Payees can present the money order at any post office or post office agency. Money orders may also be deposited into a bank account.

☞ 5.4 Activity 9

Describe what 'salim mony quik' is and how it works.

Lay-by

This is a way of paying for goods in instalments over a fixed period of time. The goods remain at the store and you do not own them until all or a specified part of the price is paid. The store can select the length of the lay-by period and the instalment periods and amounts. Stores can choose whether or not they offer a lay-by system.

Assume that you want to lay-by a stereo. It costs K140. You make your lay-by on 1 April. The store asks for a deposit of K25 per cent of the price. The lay-by period is eight weeks and you have to make a payment every two weeks. You can be using your stereo by the beginning of June. Many people find that this is a convenient means of payment. They might choose to spread the payments over a few pay periods. They won't have to pay interest but they may have to pay a cancellation fee if they decide that they do not want the good. In the event of cancellation, they will be entitled to a refund of the amount that they have paid less the cancellation fee. The fee is likely to be around 20 per cent of the purchase price of the good.

☞ 5.4 Activity 10

Using the above example - calculate how much you would have to pay each time if you made four equal payments off your lay-by. Calculate how much you would have to pay for a 20 per cent cancellation fee.

Continuing credit

Continuing credit with the larger stores involves paying with a charge card, such as the Courts card. Using the store charge card is similar to using a bankcard, except that it can only be used in the store chain which issues it. You are entitled to continuous credit up to the credit limit which has been issued to you. The law refers to this type of arrangement as a continuing credit contract.

Loan contracts

A specific item (for example, a television or a refrigerator) can be bought by borrowing money from a finance company. The finance company pays the full price of the item to the seller of the good. The borrower then repays the finance company. Repayments are made in instalments at regular intervals usually over a fixed term. Many people find that this is a very convenient means of buying expensive items. The main drawback is that it is an expensive way to buy as the interest rates are high. This type of credit is not only used in retail stores but is very common for buying cars. The buyer enters into a loan contract with the finance company or lender. The good belongs to the buyer while the repayments are being made.

☞ 5.4 Activity 11

Study a Courts advertisement from a catalogue or the newspaper. Work out the difference in total price paid for five items if you pay a monthly repayment or the total price at the time of purchase.

Personal loans

Personal loans from banks can be used for a variety of purposes including the purchase of goods, paying education expenses or financing a holiday. Similar loans are available from credit unions and from finance companies.

Overdrafts

People with cheque accounts may be allowed to write cheques for more than they have in their accounts. This form of bank credit is used much more by businesses than it is by consumers.

Topic 6 - Choosing the right credit

Before entering any credit contract, you need to be aware of its details. You need to compare it to other credit arrangements before you can make an informed decision about which means of payment best suits your needs. There must be good reasons why banks, for instance, offer a range of different credit facilities - personal loans, overdrafts and credit cards, or why retail stores offer lay-by, credit cards, their own charge card, loans and credit sales agreements. Not all credit involves the same costs. Some of the points that you should consider when buying credit are:

- The interest rate
- The deposit required
- The existence of up-front fees (sometimes you have to pay to establish the credit account, eg in the case of a personal loan)
- The time period over which the credit is repaid (the longer the time you have to repay, the more interest you pay, even though your monthly repayments will be lower)
- The security required (sometimes the lender will ask you to pledge one of your assets to safeguard against loss if you do not repay the loan on time)

Make sure that you ask about each of these points before you agree to use credit. Don't be pushed into a credit arrangement by a sales assistant and never sign any documents until you understand what you are signing. Many sales assistants will present you with a document and say 'sign here' without giving you time to read the document. Credit contracts are legal documents. Once you sign the documents, you are bound by the conditions. If you can't understand a document, ask a reliable person to explain it to you.

The interest rate

One of the aspects of credit which can be confusing is the interest rate that is being charged. Interest rates are always expressed as a percentage. You pay a percentage of the amount which you borrow in interest. However, unless you do some calculations, the amount which you think you are paying in interest might not be the same as the amount you actually pay. There are a number of points which you should always check.

How often is the interest calculated?

Which interest rate sounds the lowest: 0.06301 per cent per day; 0.9167 per cent per month; or 23.000 per cent per annum (yearly). In fact, they are all the same interest rate. But it sounds much better if you are told that borrowing $K1000 for a year will cost you 63 toea per day than being told that the cost is K230 over the year. Always compare interest using annual percentage rates, ie per annum rates.

☞ 5.4 Activity 12

Find examples of businesses or banks that advertise monthly or daily interest rates. Work out the annual rate of interest payable at the same rate. Use K1000 as your loan total.

What type of interest rate - flat or reducible?

Find out whether you are paying a flat interest rate or a reducible interest rate. If you borrow money under a flat rate of interest, you pay interest on the original amount borrowed (the principal) over the whole term of the loan. If you borrow at a 10 per cent reducible (effective) rate of interest for five years, you would make interest repayments on the amount of the loan which you had left to repay each year. A flat rate of 10 per cent is approximately the same as a reducible rate of 19 per cent per annum. A good rule of thumb is to double the flat rate and subtract one to calculate the true effective (reducible) rate. Always convert flat rates to reducible rates if you are comparing the costs of two different credit contracts.

Is the rate fixed or variable?

You should also find out whether the interest rates are fixed over the term of the loan or can vary at the lender's option (variable rates). Usually the interest rate is fixed for consumer credit (except house mortgages). That means that if you borrow at an interest rate of, say, 20 per cent per annum, you will pay 20 per cent per annum interest throughout the term of the loan.

Some loans offer variable rates. The attraction for consumers is that if interest rates come down (say from 20 per cent per annum to 18 per cent per annum), their interest repayments will decrease.

☞ 5.4 Activity 13

Your parents have borrowed K5000 to pay fees for you and your sister.

Use your calculator to work out the daily interest rate if the annual percentage rate is:

- *25 per cent per annum; and*
- *20 per cent per annum.*

Give the corresponding reducible rate if the flat rate is:

- *12 per cent per annum;*
- *15 per cent per annum; and*
- *18 per cent per annum.*

Give the corresponding flat rate if the reducible rate is:

- *30 per cent per annum;*
- *28 per cent per annum; and*
- *26 per cent per annum.*

Topic 7 - Bankruptcy

A person is declared bankrupt when it is clear that they have no chance of paying their debts. In many cases, excessive use of credit is the major cause of bankruptcy. Almost all a bankrupt's assets will be handed over to a trustee to reimburse creditors. A bankrupt is forbidden by law from certain business activities, such as being a company director. However, bankrupts can obtain a legal discharge from bankruptcy, with only a limited proportion of debts being repaid.

Debtors who were unable to meet their financial obligations were harshly treated under the legal systems of most countries until relatively recent times. During one period in ancient Rome, creditors were entitled literally to divide a debtor's body or to enslave debtors and their families. Laws now usually allow a debtor to retain some exempt property in order to permit the debtor's family to maintain a minimum standard of living.

The main options in the case of a company that is insolvent are as follows.

- **Liquidation** entails the sale of all the company's assets for cash, which is then disbursed to the claimants in order of their seniority (for example, bondholders before shareholders).
- In **receivership**, a receiver is appointed by a senior claimant (often a bank) to run the company. The receiver will decide whether to maintain the company, in order that it may be sold as a going concern or sold in part, or liquidate to realize funds with which to repay creditors.
- **Administration** entails the appointment of an administrator, who takes control of the company and works with the interests of all claimants in mind (rather than just the senior claimants).

These options vary in their application: companies often put themselves into receivership to give themselves time to order their affairs, whereas liquidation is usually initiated by creditors or receivers.

☞ 5.4 Activity 14

What is the main cause of bankruptcy in PNG?

Section 3 – Insurance

Topic 8 – What is insurance?

Insurance, in law and business, is an arrangement that provides compensation if or when a particular set of circumstances, such as death or personal injury, accident, unemployment or old age, loss of or damage to property, occurs.

The insurer collects relatively small contributions from many people in order to create a fund that is used to reimburse those insured that actually suffer from an unforeseen event. The contributions of the policyholders are called **premiums**. The insurance terms are written in a **policy** that explains how the insurer agrees to **indemnify** the policyholder for loss as a result of the payment of stated premiums.

The event insured against must be possible but not certain to occur in a given period of time and must be substantially beyond the control of either insured or insurer. The policyholder must generally have an insurable interest, that is, the policyholder must be one who would suffer a material loss by the happening of the event.

Insurance companies constantly search for additional business by providing insurance protection against new types of hazards. Most standard homeowners' policies do not protect against catastrophes, such as earthquakes, nuclear explosion or radiation, or war. Events often covered by insurance include accident, burglary, theft and vehicle collision.

Insurance is also available to cover the extension of credit and to guarantee the title to a property, or as part of a mortgage policy. In addition, specialized types of insurance cover damage to glass, boilers and machinery, lifts, animals, and other property, as well as losses to property arising from lightning, wind, storms, insects, explosion, and water damage. Many insurance policies are comprehensive, that is, they cover a group of related perils; but most also have exclusion clauses, detailing what events are not covered by the policy.

An **Act of God**, in law, is an occurrence not caused by human intervention or negligence, such as lightning or floods. Ordinarily, no person may be held legally responsible for the injuries and losses such events may inflict, because they are beyond human control. For example, a failure to deliver goods at the time contracted because unforeseeable floods have halted all transport does not result in liability for legal damages. Most insurance policies against property damage do not provide compensation for the consequence of acts of God.

Insurance and business

Insurance plays a major role in the modern economy, providing an orderly means for the replacement of property lost or destroyed and for sustaining purchasing power adversely affected by illness, injury, or death. In addition the huge reserves accumulated by insurance companies to meet expected claims are invested, thus providing industry with needed funds for capital expansion or other investments.

Insurance companies are owned by their shareholders, who in return for providing the company with capital by their share purchases, share in the profits in the form of dividends.

Mutual insurance companies, however, do not issue shares but operate solely on the money obtained as premiums; these organizations are owned by the policyholders, who share in the profits and losses.

Non-profit insurance corporations are cooperatives maintained and operated for the benefit of their members and subscribers. Welfare insurance plans generally are trust funds established or maintained in some countries by employers and their employees to provide life insurance, health benefits, and pensions to employees.

Certain types of insurance are provided in most countries by governmental organizations. Notable examples include social security and health insurance, although in many countries government insurance is only partial, with the individual having to bear some risk.

American Home Assurance Company

Insurance Commissioner's Office

Mitsui Marine & Fire Insurance Company Ltd

Motor Vehicles Insurance Limited

Pacific MMI Insurance Ltd

QBE Insurance (PNG) Limited

Southern Pacific Insurance Company (PNG) Limited

Tower Insurance (PNG) Limited

Workers Mutual Insurance (PNG) Ltd

Insurance companies in PNG

Liability insurance

Liability Insurance is a type of insurance used to cover the risk of incurring legal liability to pay money damages. Such insurance guarantees financial protection to an insured party who might be required to pay damages resulting from negligence. The negligent act may be one that causes personal injury, death, or property damage. Liability for negligence may result not only from the conduct of the insured, but also from the conduct of his or her agents and employees. Acts of negligence resulting in liability occur in connection with a wide variety of private and commercial activities, such as the operation of a motor vehicle, the conduct of a business, and the ownership or occupancy of property. Liability insurance sometimes is called **third-party insurance**, because the insurance company protects the insured against claims by a third party, that is, the claimant.

Life insurance

Unlike loss in insurance on property, loss in **life insurance** is certain to occur and is total. The element of uncertainty is when death will occur. Mortality is subject to the laws of probability, however, and life-insurance premiums can be calculated from mortality tables, which indicate the average number of people in each age and gender group that will die each year.

The earliest known type of life insurance was the burial benefits that Greek and Roman religious societies provided for their members. Death benefits were frequently financed on a post-assessment basis; that is, contributions were made by all surviving members following one member's death. As a result, funds were not always available to pay claims.

Ordinary life insurance may be used to provide a lump sum or continuing income to family beneficiaries, or it may be used by a firm to insure the life of a business executive. Premiums are paid on a periodic basis. With the exception of term life insurance, ordinary life insurance builds cash values that can be borrowed to help families meet emergencies or take advantage of business opportunities. A medical examination usually is required to buy life insurance.

Whole-life insurance provides for the payment of the face amount of the policy on the death of the insured, whenever it might occur. Premium payments are made during the entire lifetime of the insured person; this differs from limited-payment and endowment policies. The cash value of the policy, which is less than its face value, is paid when the contract matures or is surrendered.

The limited-payment life policy is a subtype of whole-life policy providing for premium payments for a specified number of years (for example, 10 or 20, or until age 65) unless the insured person dies sooner.

Endowment policies are payable at the death of the insured or on a specified maturity date if the insured is alive. Premiums generally are payable from the date of issue until the date of maturity but may be limited to fewer years or even to a single lump-sum payment. Premium payments on endowments are high because a large cash value is built up in a relatively short time. Endowments combine savings with insurance, and such policies may be used to provide for education, mortgage payments, or retirement purposes.

☞ 5.4 Activity 15

Collect brochures about insurance policies from different insurance companies and compare their terms and conditions.

Interview people/business owners who had insurance and were affected by natural disasters such as the Rabaul volcano eruptions. How successful were they in obtaining compensation for loss and damage?

Topic 9 - Workers' compensation

Laws concerning **workers' compensation** were passed in Germany in 1884, in Great Britain in 1897, and in several states of the United States from 1908 onward. By placing the financial burden of caring for injured workers on the employer, such laws created an incentive for providing safe machinery and working conditions, and for improved selection and training of employees. In the United Kingdom, the Health and Safety Executive is the government agency charged with ensuring that employers provide a safe system of work and a safe working environment. The Executive prosecutes companies whose workplaces are dangerous.

☞ 5.4 Activity 16

Find out more about workers' compensation practices in PNG by interviewing people who work for large companies or for the Public Service. What protection do they have for death or injury at work?

References

Australia and New Zealand Banking Group (PNG) Limited (ANZ) (2001). *ANZ Bank Customer Forecasts*

Bank of Papua New Guinea (1999). *Money and Banking in Papua New Guinea*

Beddis, R. (1989). *The Third World – development and interdependence*, Oxford: Oxford.

Kleeman, G. et al (1998). *A Geography of Global Environments and Communities*, Heinemann: Melbourne

McInnes, D. (1995). *Dellasta Encyclopedia of Papua New Guinea*, Dellasta Pacific: Burwood

Microsoft Corporation (2000). *Microsoft Encarta Encyclopedia* [CD-ROM]

Papua New Guinea Year Book 2001 (2002).

Post-Courier – various articles

The National – various articles