2021 Annual Report

MISSION:

"Everything we do is driven by and revolves around the banking system's soundness, safety, stability and health."

VISION*:*

"Our vision is to ensure and maintain trust and confidence in the banking system by the public (our Mission) by being innovative, effective, efficient, fair, friendly, firm, and consistent in rendering and availing the right and appropriate financial and banking regulatory and supervisory supports, tools and services."

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SUMMARY ASSESSMENT

The overall condition of the FSM banking sector remains satisfactory for the year. Growth and stability still maintained.

- Total Assets of the banking system improved by 9.5% or $41.260 million for the year.

- Asset quality for the banking system for the year remains satisfactory. The industry ratio of Non-Performing Loans (NPLs) to Total Loans improved to 0.48% compared to 1.31% for the previous year. The volume of outstanding loans increased by $951K or 1.2%. Provisions for Bad Loans to mitigate against potential losses remain more than adequate at $2.731M for the year compared to $2.822M in 2020 which is about seven times the sector's volume of NPLs.

- Consumer lending declined slightly from $35.878M to $34.939M, but commercial lending increased from $42.271M to $44.161M. Overall, lending increased by $951K. Deposit on the other hand increased from $395.777M to $437.867M, due primarily to remittance from abroad and pandemic stimulus government policy.

- Return on Assets decreased from 0.93% to 0.70% over the year, primarily due to excess liquidity. Excess in liquidity was placed abroad as investment, yielding low interest returns due to global economic circumstances.

- Banking system remains highly liquid and roughly eighty six percent (86%) of the total deposit was placed abroad in the liquid investment portfolios compared to roughly eighty five percent (85%) in 2020.

- In aggregate, approximately $379.552M of the sector's $476.772M total assets are liquid assets. The banking system continues to maintain reliable access to adequate sources of funds to meet anticipated local liquidity needs.

- The banking system remains highly capitalized, core capital maintained well above the required minimum capital threshold in addition to retained earnings.

- Escheatment was reported at $89,289.74 of which $600.00 was deducted by the regulated banks for publication fees compared to $109,262.56 and $600.00 respectively in 2020, for an aggregated total amount of escheatment of $1,102,895.91 at year end 2021.

- The two regulated banks-maintained FDIC deposit insurance coverage. One of the two banks is a foreign bank incorporated in the US territory of Guam and is required to maintain required level of capital by its home jurisdiction, and not required to maintain capital or assigned capital in FSM.

- Because of the COVID-19 pandemic the banking system put into place certain customer service strategies to help minimize the impacts of the pandemic, i.e. social distancing, ATM and on-line banking encouraged, voluntary loan repayment or deferment instituted to help coped with pandemic financial difficulties. The strategies are in line with the guidelines from the US Regulators and FSM Banking Board.

- Of particular potential challenge before banking sector is the expiration of the economic provisions under the renewed Compact of Free Association comes 2023, specifically the Article XI of the renewed Compact, i.e. the FDIC insurance coverage, technical assistance, established critical and important banking corresponding relationship with the US banking system, loan repayments by those drawing their salaries from grants and fundings under the renewed Compact, among others.

NEW DEVELOPMENTS

The performance of the banking system in the FSM is closely linked to the economic circumstances, both domestically and internationally.

Covid-19 Pandemic:

The banking system is vulnerable to the impacts of Covid-19 pandemic. The Board works with the regulated banks and relevant international organizations, including FDIC on appropriate strategies to minimize and mitigate impacts of Covid-19 on the performance, safety, soundness and stability of the banking system.

Specifically, FDIC issued a statement (*Annex II*) acknowledging that the pandemic is unique and an evolving situation that could pose significant disruptions and challenges. FDIC encouraged banks to work with customers and communities. In essence, these measures include, for example, encouraging a bank's prudential efforts to modify the terms on existing loans for affected customers and for insured banks not to be subject to examiner criticism. Specifically, for existing loans, FDIC encouraged banks to consider allowing loan repayment deferment. The Board held meetings with the banks and encouraged the banks to consider the FDIC Statement on a case-by-case and voluntary basis.

Economic Impact Payments (EIPs):

The banking system received EIPs from the US Treasury via electronic transfer or paper check. Some of the EIPs received were in fact issued erroneously after verification by the banking system and such EIPs were not honored or accepted. The US Treasury established a website to enable the banks to verify authenticity or legitimacy of EIPs. The verification period (usually three to ten days) is a normal procedure, among others, as a way to safeguard the safety, soundness and stability of the banking system.

Climate Change:

Climate change implication on the banking system is real. The risks of climate change could manifest themselves in the form of credit, market, and liquidity of the banking system. Ways to minimize and/or mitigate such risks is a great challenge before the Board and the banking system. As such the Board engaged in the discussions with DECEM and relevant international organizations. The global understanding shared by bank regulator and supervisor advocates for supplementary actions through modifications to various regulatory standards, such as Pillar 1 (risk weighted assets), Pillar 2 (supervisory review processes and capital add-ons capacity to absorb loss) and/or Pillar 3 (disclosure obligations) to help mitigate climate change and at the same time to minimize the impacts on the soundness, safety and stability of the banking system.

One consideration explored by the Board with DECEM was a financing mechanism, whereby Climate Fund could be established as seed funding either on a grant or guaranteed basis with minimal interest rate for borrowers in need, for example, to relocate from shore areas to higher grounds due to sea-level rise. Also discussed with DECEM was funding for housing projects that incorporate measures to mitigate climate change, i.e. solar energy, among others.

The Legal tender in the FSM is the US Currency.

Cryptocurrency:

Cryptocurrency has surfaced and been accepted in other parts of the world as a substitute or alternative form of payment for goods and services among and between cryptoholders.

The Board participated in various virtual meetings sponsored by international organizations, such as IMF, World Bank and other Central Bank Authorities.

The Board; however, still has much to learn about cryptocurrency as to how it actually works, especially in view of important public interest issues such as safety, confidentiality, stability, among many others. So far, it is understood that cryptocurrency is a digital asset that is built on blockchain technology and is decentralized in nature. It is not regulated in the same way as currency involving central banking and intermediary banking systems. So, for example, in the event of a financial crisis, the cash currency or assets allows the government (central bank) to borrow funds to keep the economy going and stabilize the cash currency, for example, inflation. The Board believes this mechanism is flawed in the cryptocurrency because it lacks the backing and mechanisms instituted by the government authority, i.e. a central bank of a State. Yet some believe cryptocurrency is better because it introduces innovation and efficiency in financial transactions for it does not involve financial intermediary (a bank) and of course the central banking system.

Presently, the only legal tender in the FSM is US Dollar, so there is currently no legal framework for governing cryptocurrency. The Board will continue to engage in the discussions and learning more about cryptocurrency.

Mutual Cooperations:

The objective is to enhance capacity building, mutual cooperation, and sharing information as relevant to international financial transactions. However, due to the pandemic, the scheduled trainings and meetings in 2021 and partially 2020, including FDIC Examination School Classes did not take place.

The Banking Commissioner, Banking Examiner and Banking Financial Analyst were all accepted to FDIC School; however, FDIC cancelled all the classes due to the pandemic. The Banking Commissioner was accepted to a course that covers all five schools, and usually not offered to any non-US territory regulator. The Bank Examiner has two more FDIC classes to complete for the entire FDIC Examination Management School, while the new Financial Analyst was also slated to take the first FDIC course. All other scheduled meetings and trainings were cancelled, as well.

Due to the pandemic; however, the international regulatory and supervisory authorities shifted focus to virtual meetings to guide country banking authorities to learn more about the implications and possible strategies to minimize the impacts of the pandemic on the banking system's safety, soundness and stability.

The Bank of Guam also conducted an AML/BSA webinar training in 2021 (usually on an annual basis) intended for Bank of Guam clients. The Banking Commissioner and Banking Examiner were invited and participated in the webinar.

The Annual Meeting of Pacific Island Financial Supervisors did not take place for the past two years due to the pandemic. Sensitive and myriad of information is usually shared among members as a way to safeguard the Pacific region from unauthorized and unacceptable banking transaction activities.

The Board has in place established mutual cooperation arrangements with recognized regulatory and supervisory authorities in the region, US and other international authorities.

Onsite Examination:

Annually, FDIC Examination Teams visit the FSM to conduct both the Financial Examination and the Consumer Compliance Examination. However, due to the pandemic and border closure, these examinations were conducted virtually. The Commissioner and staff took part in the examinations. Participation in person of Board staff in these examinations have been proven better in terms of capacity building compared to participation via virtual mode.

No on-site examination was conducted in 2021 by the Board due to Covid-19 uncertainties and restrictions. However, off-site monitoring and examination were enhanced and conducted as part of the ongoing efforts to closely monitor the performance, soundness, safety and stability of the banks.

Technical Assistance (TA) on Legal Framework and Prudential Regulations:

The Banking Board requested a Technical Assistance from IMF through the Pacific Financial Technical Assistance Center (PFTAC) comprising of three phases, (1) review of the Banking Act and specific recommendations for possible amendments, (2) drafting of amendment bill and regulations, and (3) implementation.

The first phase of the TA entitled Legal Reform of Banking Supervision, Regulation and Resolution comprised of Mr. William Stutts (banking legal expert) and Mr. Joel Hefty (banking prudential standard expert). The Banking Act and accompanying regulations reviewed and recommendations made. The aim was to align the provisions of the Banking Act with international banking legal standards. Recommendations focused in the areas of: (1) governance and institutional arrangements (2) risk management, (3) operational risk (4) licensing (5) liquidity risk (6) credit risk (7) enforcement and penalties, (8) resolution and receivership.

The second and third phases of the TA were placed on back-burner due to COVID-19 pandemic. Once the "lockdown" is uplifted, conversation will resume with IMF as to the appropriate time for the other two phases. The Board hopes for the technical assistance team to be physically present in the FSM to assist with the drafting and presentation of the draft prudential regulations. The third phase will focus on the implementation, which will include, for example, updating, training and issuing the necessary forms.

TA on Financial Soundness Indicators (FSI) Technical Assistance:

FSM Banking Board serves as the focal point for IMF Financial Soundness Indicators (FSI). FSI reporting template and instructions changed in certain respects so the Board requested and received a TA aimed at improving staff capacity in the collection, compilation and reporting FSI data. FSI data, if accurately reported and properly compiled, is imperative for gauging the health and soundness of individual financial institutions and the overall financial system of the country. It is therefore useful indicators of past and current financial health and soundness of the financial institutions, and of their corporate and household counterparts.

The TA was conducted in virtual mode for a duration of one month, and during the implementation, it was found FSM was behind submission of required data for a few years. However, the Banking Examiner and Bank Financial Analyst were able to compile and update all the data during and immediately after the TA.

During the TA, certain areas in the CALL Report were identified as weaknesses and should be strengthened. The CALL Report template and its Instruction need updating to allow the Board and IMF to have further understanding and assessment on the health and soundness of the individual bank and the financial system. As such, a TA was requested to help the Banking Board in this effort; however, the follow-up TA is hampered by the COVID-19 and border closure. Discussion will resume with IMF in the regard when border closure is uplifted.

TA on AML/CFT:
AML/CFT TA was discussed and initiated with the assistance of FSM Department of Justice; however, the technical expert could not visit the FSM due to border closure/pandemic. Discussion will resume when the border is reopened. The objective of the TA was to provide on-hands training on analyzing and interpreting SARs.

Banking Permit/License Applications:

There were two queries into obtaining a permit and license to engage in banking business in the FSM. As such, a comprehensive application package was put together (*Annex III*), taking into account, among other important factors, the statutory requirements and other banking prudential practices. One of the queries did not pass a formal filing of the application, while the other actually resulted on filing of an application that was incomplete.

The applicant was given an opportunity to complete the application. However, the applicant failed to do so.

IMF Article IV Mission:
Meetings held with IMF Article IV Mission to discuss overall performance of the banking system, provisioning of technical assistance and reviewing status on pending technical assistance. The Mission emphasized and the IMF Directors agreed on the need to continue upgrading the legal and regulatory framework for the banking supervision and enhancing the Banking Board's supervisory capacity. The Mission noted that placing the FSM Development Bank and Credit Unions under the supervision of the Banking Board would help ensure effective supervision and prudent lending. IMF Directors underscored the importance of strengthening AML/CFT risk-based supervision to preserve U.S. Dollar correspondent banking relationships.

Annual AFSPC Meeting:
The 2020 and 2021 annual meetings of the Association of Financial Supervisors of Pacific Island Countries (AFSPC), Banking Board as a member, was cancelled due to the declared COVID-19 pandemic. FSM has never been the host. However, during the 2019 Annual Meeting, AFSPC decided FSM be the host for the 2021 Annual Meeting. This was aimed to coincide with the opening of the National Government Conference Center in Palikir.

Website:
The Board hired a consultant to assist with the design and upload of its website, another means for availing information to the general public. The website was completed in 2021 and with the help with TC&I available at: www.bankingboard.gov.fm.

North Pacific Supervisor College:
FSM, Palau and RMI Banking Commissioners discussed forming the North Pacific Bank Supervisory College. The objective is to share information and work together toward standardizing financial returns and other forms that banks are required to file, including transition from hard-paper filing to electronic filing. The aim is to also help with cross-border banking issues, transparency and convenience on the part of the banks that have operations in the three regions. The foreign bank operating in the FSM, Palau and RMI is in full support of the formation of the North Pacific Supervisory College and standardization of required forms or templates. PFTAC is willing to assist in the effort when border is re-opened.

BACKGROUND & GENERAL OVERVIEW

The FSM signed a Compact of Free Association (Compact) with the U.S., entered into force on November 3, 1986. Certain provisions of the Compact renewed and now slated to expire in 2023, including FDIC Insurance Coverage for Bank of FSM under Article XI, which also subject the Bank to applicable US banking and related laws, regulations, rules, supervision and prudential standards.

The Board is required under the Banking Act to produce Annual Report which should provide the general description of the condition of the banking system and operation of the Banking Board. This Annual Report focuses on the year 2021; however, other parts of the Report will provide information on previous years for comparative purposes.

On May 10, 1979, four of the Trust Territory districts (Yap, Chuuk, Pohnpei and Kosrae) ratified the Constitution of the Federated States of Micronesia. In 1980, the FSM Congress passed the Banking Act and signed into law by the President as Public Law 1-94, as amended, and codified under Title 29 of the FSM Code.

In view of the above general mandates, the Board as the supervisory entity is charged with especially the microprudential policies of the banking system, ensuring regulated banks comply with the provisions of the Act, regulations and banking prudential standards. This involves activities relating to monitoring, inspecting, and examining banks to ensure adherence to the laws and regulations and that they operate and develop in a safe and sound manner for a stable banking system. Additionally, the Act grants authority to the Board to promulgate regulations for effective execution and implementation of the Act.

The "stability and development" elements of the mandate relate to the macroprudential policy activities for achieving the desired financial stability outcomes. In a nutshell, the overarching goal is to minimize probability of failure by making sure the bank manages risks prudently, has plan in place to restore itself to financial and operational soundness in case of a shock, sufficient capital buffer to absorb losses while remaining viable, sufficient liquidity to meet obligations as they become due, among others. The Board in discharging its microprudential responsibilities also helps to promote stability and resilience of the financial system and, through that, help to contribute to the overall objective of promoting sustainable economic growth and societal welfare.

It should be noted; however, that the FSM's legal tender is the US Dollar, thus technically speaking, certain macroprudential policy activities in respect to "stability" might be difficult. However, the FSM has enacted certain legislations, including the Consumer Protection Act (P.L. 10-52) or Title 34, Chapter 2 which specifically cap the credit transaction interest rate at 24%. The average prevailing interest rate charged by the banking system in 2021 was 12.62% for consumer loans and 7.57% for commercial loan.

Principal purposes of the Board:

- To undertake the licensing and supervision of banks;
- To protect the interests of depositors; and
- To promote the soundness, safety, stability, and development of the banking system.

There are several financial institutions in the FSM. Two of them fall under the supervisory purview of the Board, the Bank of FSM which is a domestic bank and the Bank of Guam which is a US bank incorporated in the territory of Guam. The definitions of "bank" and "banking business" in the Act exempt the other financial institutions from the regulatory and supervisory purview of the Board. Both banks have presence in all the four States. Also, both banks are US FDIC insureds for up-to $250,000 each deposit.

The total number of employees employed by both banks at end 2021 was 130. The system realizes a net income of $3.269M for the year compared to $3.806M in 2020.

The pandemic; however, led the banks to alter certain operational activities, i.e. social distancing, voluntary loan deferment program, among a few others, most of which encouraged by FDIC and the Board. The objective is to help minimize potential impacts of the pandemic on the banks, customers and communities.

Increased in deposit realized, due mostly to the domestic and foreign governments and donor stimulus supports. The Economic Impact Payments from the US Treasury; however, became a potential concern as some recipients were not qualified to receive such payments. However, the US Treasury and banking system instituted mechanisms to control and minimize the negative impacts, i.e. an average of 10 days verification period.

Structure of the Board/Commission:

The Board or Commission is governed by three members, who are appointed by the President subject to the advice and consent by Congress. The Board is responsible for its own policy. The term for each member is four years; however, can be perpetual until a member is replaced. The Banking Commissioner is appointed by the President without term limit, who serves as the CEO and Ex-Officio member. The staff is employed under the National Government Public Service System, thus subject to the regulations of the Public Service System. Currently, staff includes (1) Bank Examiner, (2) Financial Analyst, and the secretary/administrative officer. The FSM Department of Justice serves as the legal counsel for the Board as provided by the Banking Act. The Board is also permitted under the law to receive other supports from the Government through the President's Office, such as support from the Public Auditor. The Governing Board convened on a quarterly basis, even after resignation of one member in 2021, quorum still maintained. Potential replacement for the vacant seat recommended. Quarterly financials of the banking system required reviewed and submission to the President and the Speaker by the Board, copies are availed to the public. A website was established to help with the dissemination and publication of such reports, as well as other information and activities of the Board for interested general public.

Commissioner is responsible for the overall regulatory and supervisory functions which includes, for example, the execution of the Banking Act, any bank related laws, regulations, policies and other prudential banking standards as provided under the law. The Commissioner is responsible for the overall management and implementation of policies, duties and activities of the Board. He is also responsible for ensuring all FDIC imposed requirements are in compliance with by the FDIC insured bank as required under Article XI of the amended Compact. All bank examination reports are subject to the final approval of the Commissioner.

Examiner is primarily responsible for the on-site examinations and overall off-site monitoring analyses and related activities. The Examiner is assisted by the Financial Analyst. As the senior staff, he supervises and oversees the works of other staff, including but not limited to monthly, quarterly and annual analysis of individual bank and sector-wide financial returns, collection of financial sector statistics and information, in-depth and detailed review of bank documents, records, as well as general observations of bank operations. He employs the CAMELS system in assessing and rating performance of the bank which allows for the appropriate levels of supervisory actions and regulatory oversight to ensure the safety, soundness and stability of the banking system.

Financial Analyst is primarily responsible for off-site examination, monitoring and analysis. This involves the collection, review, analysis, and detection of trends and/or singular events that may impact banks' financial condition. This off-site monitoring of financial institutions is conducted monthly, quarterly and as needed in order for monitoring and analysis to take place. This process provides for the opportunity to undertake necessary supervisory action as needed.

Executive Secretary/Administrative Officer I is responsible for providing administrative assistance to the entire operation. Those include but not limited to the maintenance of records, documentation processing, preparation monitoring and analysis of budgets, reporting, procurement of supplies and services, tracking and monitoring, among other clerical and related operational and administrative functions.

In 2021, there were two turnovers in staff. The Financial Analyst and Executive Secretary resigned to relocate and to accept other job offer, respectively; however, their replacements were hired. The Executive Secretary position was reclassified to Administrative Officer and funding for which provided by Congress. The job description also entails duties of the executive secretary.

Operational Budget the Board is funded annually through appropriation by the FSM Congress. Every January, the Board submits a budget proposal to the President and the Executive Budget Review Committee (EBRC) for consideration and review prior to submission to Congress in April. For fiscal year 2021, the operation budget for the Board as authorized under Public Law 21-221, as amended, was $200,618 to cover personnel, travel, contractual services, consumable, and fixed assets. Board's internal reconciliation records show an unexpended amount of about $46,309.33 at year end. Due to the pandemic and border closure, no domestic or international travel took place. Instead, most of the meetings required attendance of the Board were either cancelled or held via virtual mode. The number of meetings via cyberspace increased substantially, most of which focused on the various potential implications of the pandemic on the financial system. Teleconference and cyberspace equipment and technology were procured. Also, the Board was provided funding for the Examiner's CPA preparation course and materials under Contractual Service. *Annex IV* is attached to provide additional information, including the amount for each budget category, the reprogramming between category, expenditures, surplus, among other information.

Major Supervisory Activities of the Board:

Anti-Money Laundering (AML) and Counter Financing Terrorism (CFT)

As stated above, in addition to regular bank regulatory and supervision responsibilities as mandated and stipulated in the Banking Act of 1980, the Board also undertakes and discharges certain functions and oversights pertaining to AML/CFT. This is critical to ensuring safety, stability and soundness of the banking system. For example, in the course of off-site and/or on-site supervision and examination, the Board conducts in-depth and detailed review of bank documents, records, as well as general observations of bank operations.

The Department of Justice; however, is directly charged with the AML responsibilities under the law.

Off-Site Monitoring

As required by law, regulated banks are required to submit periodic financial reports (CALL REPORT) to the Board. Call Report is thoroughly reviewed and analyzed to assess the performances of the banks in terms of compliance with legal standards, conditions of license, strengths, safety and soundness. The analysis forms the basis for the trends and patterns in deposits, loans and other movements and changes in the composition of banks' assets, liabilities and equities. These review and analysis are among the core responsibilities of off-site supervision as outlined in the Strategic Goal No. 2 in its budget. The Bank Financial Analyst compiles, reviews and analyzes the Report prior to further review and analysis by the Banking Examiner before presentation to the Banking Commissioner and the Board.

The data and information reported on the Call Report are compiled into quarterly financial report for presentation to the Board, during which the Board is required to deliberate on such information. If the Board approves, the quarterly financial report is then submitted to the President and Speaker of Congress as required by law. The Report also serves as the basis for policy formulation of the Board. The report is then made available to the general public upon request and also via Board's established website, www.bankingboard.gov.fm.

Data submitted by all licensed banks on Call Report or financial prudential returns are entered into a computer database and used in the calculation of pertinent ratios and indicators which help to monitor the performance of individual bank and on a consolidated basis for the banking system. The database is therefore also used for off-site monitoring program and provide comparative analysis and performance tracking for each bank and banking system.

On-Site Examination

The Report received from the Bank serves as an integral part of on-site bank examination planning and scheduling. On-site examinations can either be "spot-examination" or "full-examination". No on-site bank examination took place in 2021 by the Board due to the Covid-19 pandemic. However, FDIC Examination Team conducted virtual examinations on the bank, rating on which is favorable, especially in respect to capital level maintained by the bank.

In addition, the FSM Development Bank (FSMDB) also submits periodic financial statements for compilation with that of the commercial banking system and together submitted to IMF for FSI reporting purposes.

Financial Institutions Not Regulated by the Board

As stated above, the Board received expert advice and opinion from IMF on the need to continue upgrading the legal and regulatory framework for the banking supervision and enhancing the Banking Board's supervisory capacity to include regulatory and supervisory oversight on the FSM Development Bank and credit unions. This is explicit stated in the IMF Article IV Mission. Consideration should be given to any of the non-bank entities with say more than $500,000 in total assets to be brought under the supervisory authority of the Board.

Issues and Challenges

The Federal Programs and Services Agreement under the renewed Compact of Free Association between the FSM and US will expire in 2023. Article XI thereunder spells out criteria for which FDIC's assistance and services to benefit the Bank of FSM, Banking Board and the FSM. While these benefits might not be easily quantified in monetary terms, they are indeed critical to preserving public confidence in the banking system and its safety, soundness and stability, capacity building, among others.

The assistance from FDIC has certainly raised and instilled confidence in the Bank by the public because of the deposit insurance coverage and the financial soundness and safety standards the Bank is required to comply with and maintain. Among others the compliance with US banking and related laws, rules, regulations, the established critical and important banking corresponding relationships with the US and international banking system, and other related banking requirements. For the Banking Board, the benefits are also many, including cooperation on a wide range of issues such as sharing and provisioning of information, capacity building arrangements by FDIC, technical assistance from FDIC, among others.

The financial assistance under the Federal Programs under the renewed Compact is also used to pay for wages and salaries for some in the FSM, who are the borrowers from the banks. These borrowers' ability to repay or not repay certainly have implication on the performance of the banking system in terms of income and soundness, safety and stability.

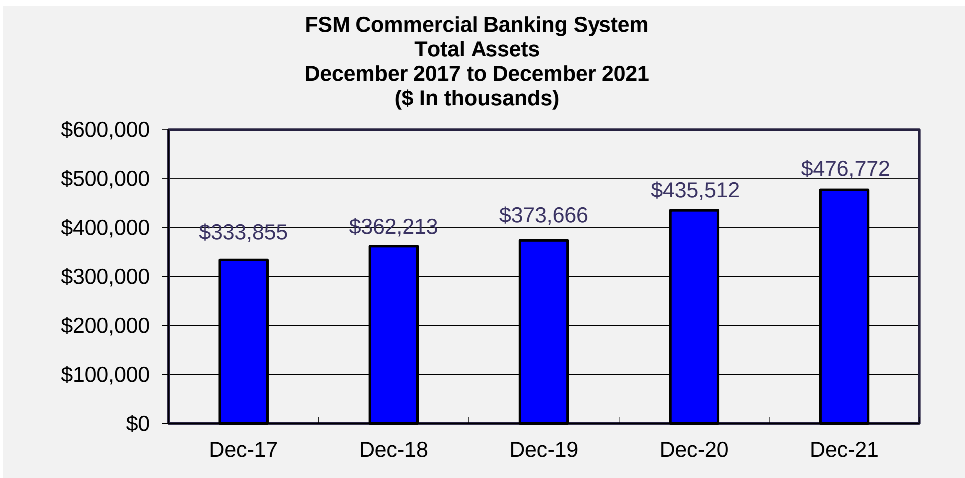
FINANCIAL CONDITION & PERFORMANCE OF THE COMMERCIAL BANKING SYSTEM

While 2021 continues to present challenges, FSM Commercial Banking System (hereinafter "the system") remained sound and resilient, while continuing to hold strong capital and liquidity positions. The overall performance of the banks was assessed as satisfactory as of December 31, 2021, based on satisfactory levels of capital, earnings, liquidity and strong asset quality indicators.

Total Assets:

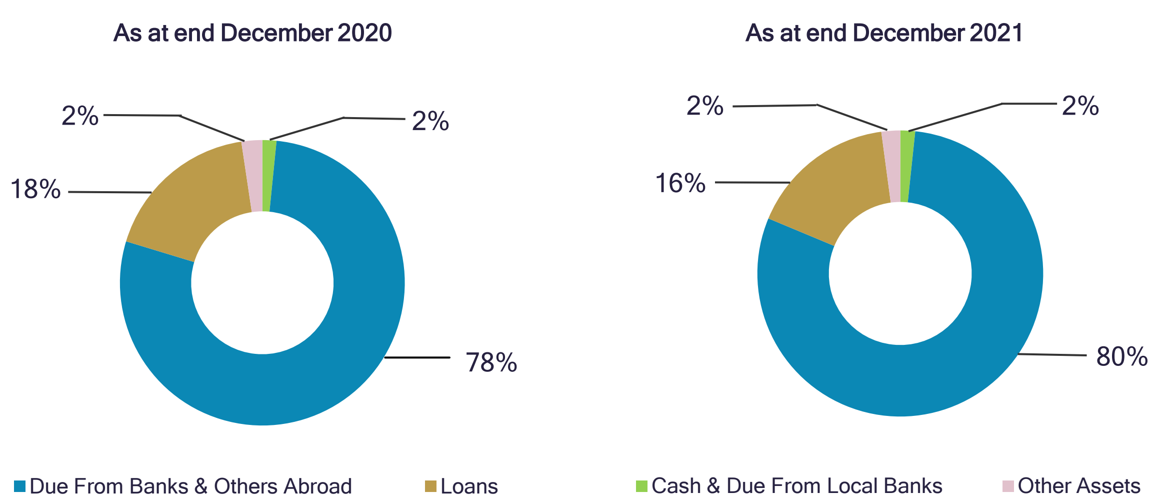
The banking system had expanded over the last five years with ***Total Assets*** increased from $333.9 million at year-end 2017 to $476.8 million at year-end 2021, as illustrated below in Chart 1. During 2021, commercial banks' combined assets rose by 9.5% or $41.5 million. The increase in assets is attributed mostly to the increase in money placement abroad at 11.6% or $39.4 million.

Chart 1: Total Assets



Foreign Assets/Due from Banks & Others Abroad comprised 80% of the system's total assets as at end-December 2021. It increased compared to 78% at end-December 2020. *Loans* made up 16% of total assets at year-end 2021, a decline from 18% at year-end 2020. *Cash & Due From Local Banks* and *Other Assets* each made up 2% of Assets as at end-December 2021, and both remained unchanged when compared to end December 2020.

Chart 2: Composition of Assets

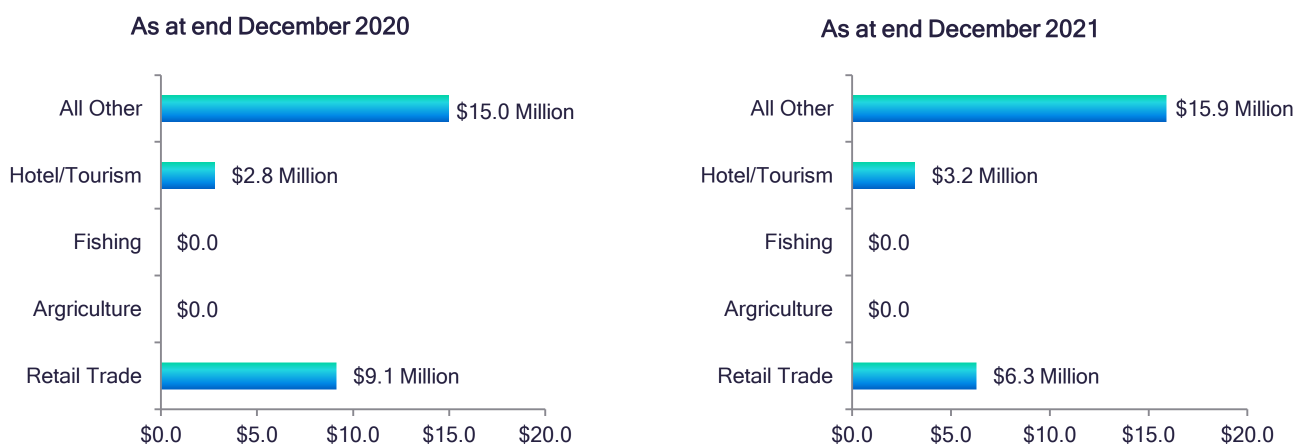


Total Loans slightly increased during 2021 by 1.2% or $951 thousand to $79.1 million. During 2021, commercial loans increased by 4.5% or $1.9 million to $44.2 million while consumer loans decreased by 2.6% or $939 thousand to $34.9 million.

Commercial lending composed 55.8% of the loan portfolio and consumer loans made up 44.2% as at end December 2021. Total *Resident Business & Nonfinancial Public Enterprises* loans stood at $18.8 million at year-end 2021. It remained unchanged when compared to 2020. Total *Nonresident Business & Commercial Purposes* decreased from $26.9 million in 2020 to $25.2 million in 2021.

Chart 3: Resident Business & Commercial Purposes and Nonfinancial Public Enterprises

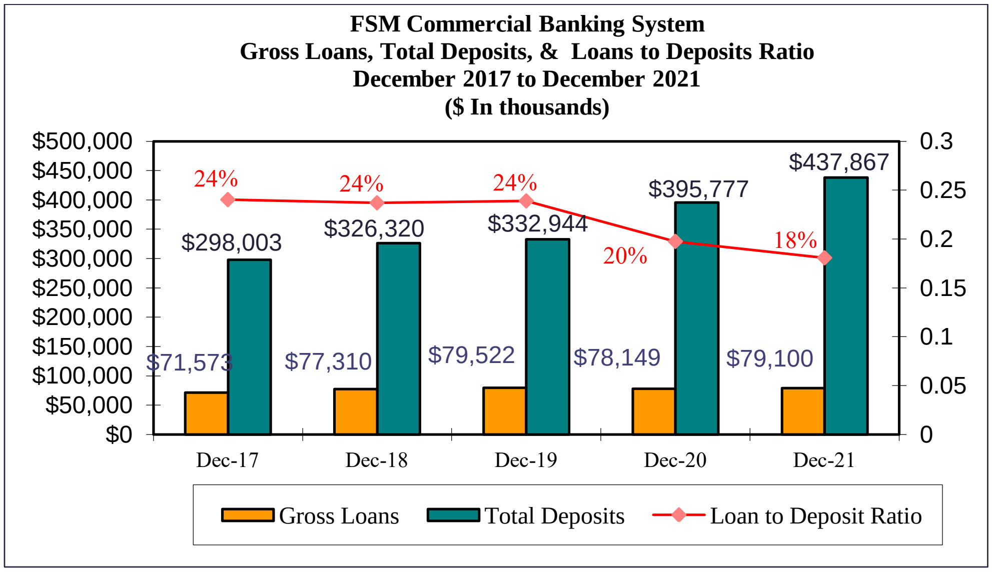
Chart 4: Nonresident Business & Commercial Purposes



Total Deposits significantly increased by 10.6% or $42.1 million to $437.9 million. The system's deposit base structure was significantly dominated by Savings Deposits at 58.9% or $257.7 million, followed by Demand Deposits (DDAs) at 33.2% or $145.5 million, TCDs at 4.9% or $2.6 million, and Other Time Deposits and Other Deposits at 3.0% or $13.0 million. The deposit facility structure remained unchanged with Savings deposits being the highest, followed by Demand then TCDs and then Other Time Deposits and Other Deposits. As of December 31, 2021, there were $34.8 million held in Private/Nonbusiness accounts, $36.9 million in Business/Commercial accounts, and $7.3 million in Nonfinancial Public Enterprise accounts.

Loan-to-Deposit Ratio for the system dropped from 20% at year-end 2020 to 18% at year-end 2021. The five-year trend in Chart 5 below shows that the Loan to Deposit Ratio is on a declining trend due to deposit growth outpacing loan growth.

Chart 5: Gross Loans, Total Deposits, & Loans to Deposits Ratio



Deposits have been the principal source of funding of banks. During 2021, total deposits significantly increased by 10.6% or $42.1 million. Looking back at the year 2020 alone, there was also an increase during the year by 18.9% or $62.8 million. The unprecedented surge in deposits in the last two years compared to their preceding years most likely reflected the funds spurred by government financial relief programs and other external assistance to assist and mitigate the health and economic impacts of the COVID-19 pandemic on businesses and households.

Demand Deposits decreased from 2020 fourth quarter to 2021 fourth quarter by $6.9 million to $145.5 million, Savings increased by $42.9 million to $257.7 million, TCDs increased by $2.1 million to $21.6 million, and Other Time and Other Deposits increased by about $4.0 million to $13.0 million.

Table 1: Aggregate Deposit Liabilities

($ in Thousands)	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4
Demand Deposits	$ 152,412	$ 163,661	$ 161,541	$ 163,641	$ 145,506
Savings Deposits	$ 214,847	$ 219,805	$ 239,034	$ 236,975	$ 257,747
Time Deposits	$ 19,439	$ 19,796	$ 19,655	$ 21,696	$ 21,585
Other Time/Other Deposits	$ 9,079	$ 10,522	$ 13,065	$ 13,206	$ 13,029

Capital Adequacy Indicators

- **The banks remain well-capitalized.** Total capital and reserves for the commercial banks decreased by 2.0%, or $582 thousand during the year to $28.6 million. The slowdown in earnings growth has resulted in capital diminution.

- The Banking Board monitors each bank to ensure it maintains adequate capital in relation to the size and nature of its business activities. As of December 31, 2021, one bank has maintained capital levels and ratios well above the minimum ratios required by the Banking Board. The other bank operates as a branch in the FSM and there is no local capital requirement pursuant to the Bank Act. However, it is stipulated in its Conditions of License issued by the Banking Board that the bank is required to maintain capital, applicable to its global operations, of not less than the capital adequacy requirements directed by the FDIC or the lawful banking supervision authorities in the country of incorporation. Based on the bank's Holding Company 2021 Annual Report, the Bank's aggregate statutory capital exceeded the FDIC's well capitalized standards.

Asset Quality Indicators

- **Asset quality is satisfactory.** Total Assets increased over the year by $41.3 million (9.5%) to $476.8 million. The expansion in the size of the banking system is commensurate with the surge in customer deposits.

- Foreign Assets/Due From Banks & Others Abroad comprise 79.6% of the system's Total Assets. Of the $379.5 million in Liquid Assets, $295.8 million are placed in interest bearing deposits with U.S. FDIC insured banks, $79.2 million are invested in U.S. Government securities guaranteed by the U.S. Government, and $4.5 million are held in excess balance accounts at the U.S. Federal Reserve. The average yield on these U.S. invested funds at year-end 2021 was 0.43%, down from 0.79% in 2020 and also down from 2.13% in 2019.

- **The quality of the system's loan portfolio is satisfactory.** The ratio of Non-Performing Loans to Total Loans was nominal at 0.48%, down from 1.31% a year ago. Outstanding Non-Performing Loans fell by 63%, or $1,022 thousand to $381 thousand at year-end 2021. Gross Loans increased over the year by $951 thousand (1.2%), a net result of the increase in commercial loans by $1.9 million (4.5%) and decrease in consumer loans by $939 thousand.

- **Loan Loss Reserves is sufficient**. The current level of loss allowance as of December 31, 2021, is over seven times the level of outstanding Non-Performing Loans for the banking system, indicating that there is sufficient cushioning that well exceeds the potential for loan losses. At December 31, 2021, the level of loss allowance stood at $2.7 million, well above Banking Board's minimum and recommended level. The banks had reported a year-to-date charge-off of $981 thousand against recoveries of $405 thousand.

Earnings Performance Indicators

- **Earnings performance for the banks is satisfactory.** The banks continued to remain profitable despite dealing in a low interest rate environment that resulted in reduced net interest income.

- The Banks managed to end year 2021 with $3.6 million in Net Operating Income owing to a continued decline in interest costs and lower provisioning for bad loans compared to previous year. Despite earnings levels going down due to fall in interest income, banks have managed to remain profitable throughout the year in spite of the COVID-19 and its attendant challenges.

- The system generated Net Income of $3.3 million for the period ended December 31, 2021, down from $3.8 million at year-end 2020. Total Interest Income has declined by $1.4 million to $8.5 million. Stable profitability is expected for the system and there continues to be potential to expand lending given sustained excess liquidity.

- Total Income was recorded at $10.3 million, a decrease from $11.6 million at year-end 2020. Albeit the expansion in banks' balance sheets over the year, total interest income shrank by $1.4 million due to low interest and constant loan growth.

- Total Year-To-Date Expenses (excluding taxes of $225 thousand) was $6.8 million, a drop by $840 thousand from $7.6 million a year ago.

- The efficiency ratio (overheads to earnings after deducting interest expense) shows how much each dollar of income is consumed by the bank's operating costs or how well the banks control their overhead/back-office expenses. The efficiency ratio at the end of 2021 was 61.9%. The ratio has deteriorated compared to 55.6% in 2020.

- Return on Average Assets/ROAA (net income as a percentage of average assets) has declined from 0.93% in the prior year to 0.70%—the decline is proportionate with the rapid pace in the banks' excess liquidity placed in offshore investments while yielding low and diminishing returns.

- Net Interest Margin/NIM (net interest income as a percentage of average earning assets) declined over the year to 1.87%, from 2.47% a year ago. The decline is mainly due to the diminished returns on offshore investments.

FSM Banking System

Consolidated Income and Expense Statement (5 Years)

(in U.S. '000s)	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21
Interest Income	10,132	12,537	13,451	9,956	8,520
Interest Expense	429	523	592	296	119
NET INTEREST INCOME	**9,703**	**12,014**	**12,859**	**9,660**	**8,401**
Provisions For Bad Loans Expense	**1,594**	**621**	**542**	**998**	**330**
NON-INTEREST INCOME	**1,831**	**1,799**	**1,991**	**1,690**	**1,801**
NON-INTEREST EXPENSE	**6,218**	**6,574**	**6,677**	**6,307**	**6,312**
Net Operating Income	3,722	6,618	7,631	4,045	3,560
Less: Taxes	290	301	295	239	291
Net Income	**3,432**	**6,317**	**7,336**	**3,806**	**3,269**

Liquidity Indicators

- **The banks have high and strong liquidity positions.**

- Total Liquid Assets stood at $387.5 million and made up 81.28% of Total Assets as of December 31, 2021. The ratio grew from 79.69% in 2020. This means that for every dollar in deposit liabilities, the banking system maintained about 81 cents in liquid assets.

- Even though local liquid assets (i.e. cash balances) aggregated for both banks cover just 1.68% of Total Liquid Assets, onsite engagements supplemented with reports confirmed that both banks maintain sufficient cash and accessible liquidity to meet depositor demands and operational needs.

- Notwithstanding concerns with the security of their respective liquid assets, banks demonstrate the ability to cover all customer deposits and short-term liabilities and rely more on capital to generate earnings.

- **All banks in the system demonstrate continued ability to meet depositor demands.**

- The ratio of Total Loans to Total Deposits declined from 20% in 2020 to 18% in 2021, commensurate with deposit growth outpacing loan growth. This ratio means that on average out of every dollar received by the banks, about 18 cents is lent out. This ratio has several implications; including those deposits continue to be taken in faster than new loans are being issued by the banks. A couple of challenges remain for FSM inhibiting any significant growth in loans. Namely, lack of legislative support for real estate secured lending and market size (i.e. limited pool of qualified borrowers). Rather than investing locally in terms of expansion in lending activities, the banks continue to place its excess liquidity in US safe and secured interest-earning-assets.

Other Banking Sector Statistics

Financial Access Survey

- At year end 2021, there were 30,033 deposit accounts at the commercial banks; of which 2,700 belong to Small Medium Enterprise (SME) accounts and 26,825 belong to household sector accounts. The total number of deposit accounts increased when compared to 29,073 at year end 2020. The increase was due to both increases in household accounts by 900 and SMEs by 56. Outstanding deposits at year end 2021 were $438.0 million; of which $127.5 million are in SME accounts and $9.8 million are in household accounts. Deposit amounts increased compared to $335.0 million in 2020. Both banks see the number of accounts increased while outstanding deposit amounts significantly increased. The increase is commensurate with the spike in deposit balances at both banks.

- The number of loan accounts at year end 2021 was 8,047; of which 105 belong to SMEs and 7,592 belong to household. Number of loans decreased from 8,009 in 2020. Outstanding loans stood at $79.0 million; of which $19.2 million are issued to SMEs and $34.6 million to households. During the year, the total balance in loans slightly declined by $1.0 million from $78.0 million in 2020.

Summary Balance Sheet

FSM COMMERCIAL BANKING SYSTEM
BALANCE SHEET
December 31, 2021

(US$ In Thousands)	31-Dec-21	%	31-Dec-20	%	Yearly Variance	% Change	Preceding Qtr. 30-Sep-21	%	Quarterly Variance	% Change
ASSETS										
Cash & Due from Local Banks	7,987	2%	6,939	2%	1,048	15.1%	8,736	2%	(749)	-8.6%
Foreign Assets/Due from Banks & Others Abroad	379,552	80%	340,133	78%	39,419	11.6%	377,476	80%	2,076	0.5%
Total Liquid Assets	**387,539**	81%	**347,072**	80%	40,467	11.7%	**386,212**	81%	1,327	0.3%
Loans					-				-	
Commercial	44,161	9%	42,271	10%	1,890	4.5%	44,557	9%	(396)	-0.9%
Consumer	34,939	7%	35,878	8%	(939)	-2.6%	33,257	7%	1,682	5.1%
Total Loans	**79,100**	17%	**78,149**	18%	951	1.2%	**77,814**	16%	1,286	1.7%
Other Assets	10,133	2%	10,291	2%	(158)	-1.5%	10,050	2%	83	0.8%
Total Assets	**476,772**	100%	**435,512**	100%	41,260	9.5%	**474,076**	100%	2,696	0.6%
LIABILITIES & CAPITAL										
Deposits										
Demand	145,506	31%	152,412	35%	(6,906)	-4.5%	163,641	35%	(18,135)	-11.1%
Savings	257,747	54%	214,847	49%	42,900	20.0%	236,975	50%	20,772	8.8%
Time	21,585	5%	19,439	4%	2,146	11.0%	21,696	5%	(111)	-0.5%
Other Time/Other Deposits	13,029	3%	9,079	2%	3,950	43.5%	13,206	3%	(177)	-1.3%
Total Deposits	**437,867**	**92%**	**395,777**	91%	42,090	10.6%	**435,518**	92%	2,349	0.5%
Other Liabilities & Capital 1/	38,905	8%	39,735	9%	(830)	-2.1%	38,558	8%	347	0.9%
Total Liabilities & Capital	**476,772**	100%	**435,512**	100%	41,260	9.5%	**474,076**	100%	2,696	0.6%
Memorandum Items:										
Loan/Deposit Ratio (%)	18%		20%				18%			
Consumer Loans (% of total loans)	44%		46%				43%			
Commercial Loans (% of total loans)	56%		54%				57%			

Footnote:

1/ Includes loan loss reserves

Source: FSM Banking Board

Key Performance Indicators

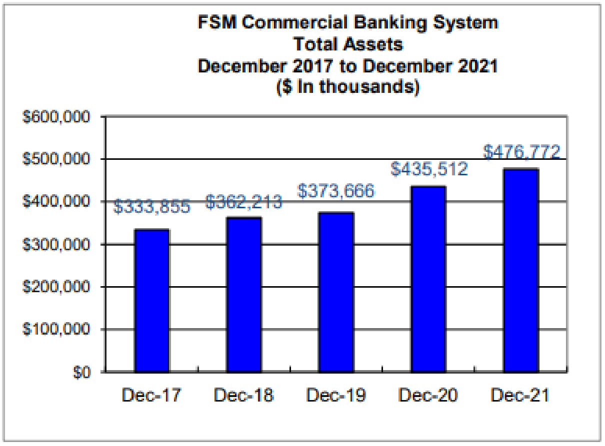
KEY RATIOS (%)	December 31, 2020	December 31, 2021
Balance Sheet Ratios:		
Liquid Assets % of Deposits	87.69%	88.51%
Total Loans % of Total Deposits	19.75%	18.06%
Consumer Loans % of Total Loans	45.91%	44.17%
Commercial Loans % of Total Loans	54.09%	55.83%
Invested Funds % of Total Deposits	85.94%	86.68%
Invested Funds % of Total Assets	78.10%	79.61%
Liquid Assets % of Total Assets	79.69%	81.28%
Asset Quality Ratios:		
Overdue Loans as % of Total Loans	1.65%	1.87%
Criticised Loans as % of Total Loans	11.24%	13.80%
Non Accrual Loans as % of Total Loans	1.31%	0.48%
Loss Reserves as % of Total Loans	3.61%	3.45%
Provisions as % of Total Loans	0.96%	0.42%
Classified as % of Total Loans	11.24%	13.80%
Classified Consumer % of Total Consumer	16.48%	3.01%
Classified Commercial % of Total Commercial	5.07%	22.33%
Interest Measures:		
Average Yield on Loans	9.74%	9.32%
Average Yield on Invested Funds	0.79%	0.43%
Average Cost of Deposits	0.08%	0.03%
Interest Spread (Yield -Cost)	2.50%	1.90%
Net Income to Average Assets (ROAA)	0.93%	0.70%
Net Int Inc to Avg Earning Assets (NIM)	2.47%	1.87%

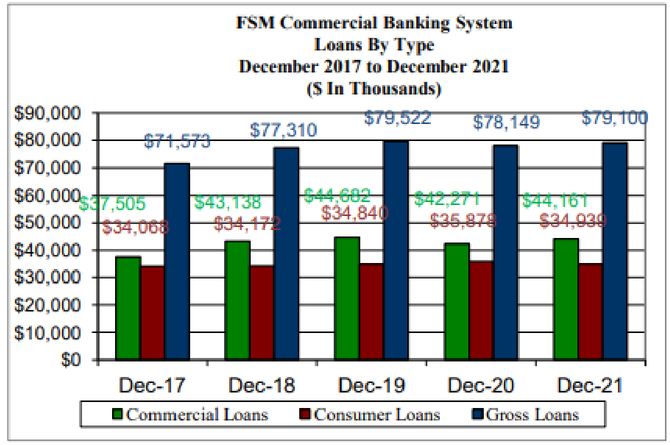
FINANCIAL SOUNDNESS INDICATORS

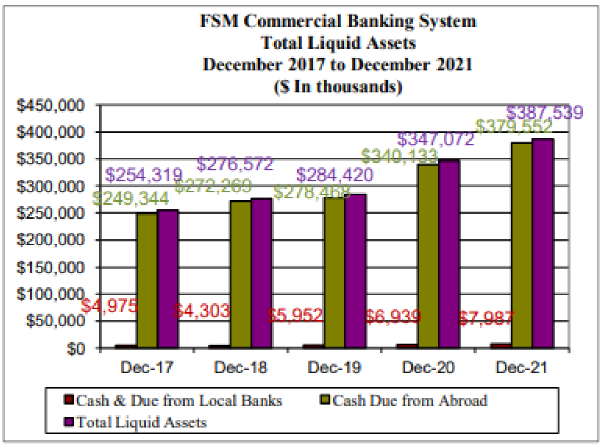
Financial Soundness Indicators (Core)	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21
Capital-based					
Regulatory capital to risk-weighted assets	35.47	33.27	35.24	37.57	37.24
Regulatory Tier 1 capital to risk-weighted assets	35.47	33.27	35.24	37.57	37.24
Non-performing loans net of provisions to capital	3.75	3.25	1.93	1.05	2.90
Asset Quality					
Non-performing loans to total gross loans	1.41	1.21	1.25	0.60	1.28
Sectoral distribution of loans to total loans:					
Residents	69.66	66.52	65.86	65.32	68.16
Interbank loans	-	-	-	-	-
Other financial corporations	-	-	-	-	-
Non-financial corporations	68.65	59.68	59.51	59.24	62.88
Other domestic sectors	1.01	6.83	6.34	6.07	5.28
Non-residents	30.34	33.48	34.14	34.68	31.84
Earnings and Profitability					
Return on assets	1.05	1.80	1.98	0.91	0.70
Return on equity	15.18	25.59	26.23	13.29	11.71
Interest margin to gross loans	84.13	86.98	86.59	85.12	82.35
Noninterest margin to gross income	84.13	86.98	86.59	85.12	82.35
Liquidity					
Liquid assets to total assets	58.64	61.12	62.24	58.53	67.35

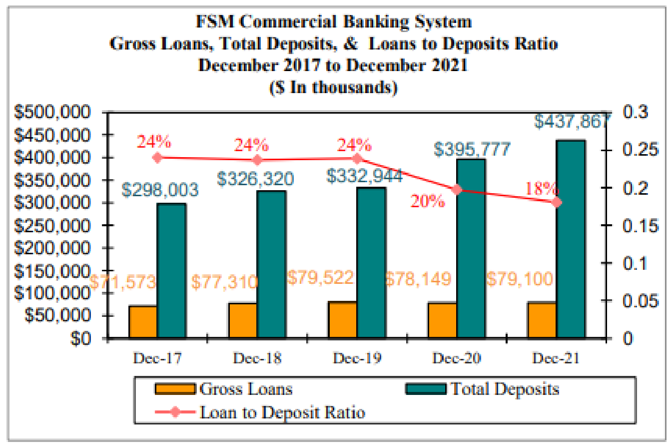
Financial Soundness Indicators (Encouraged)	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21
Capital to assets	6.21	6.02	6.11	5.59	5.34
Customer deposits to total (non-interbank) loans	416.36	422.09	418.68	506.44	553.56
Personnel expenses to non-interest expenses	45.34	45.57	45.88	51.80	50.16
Foreign-currency-denominated loans to total loans	0.00	0.00	0.16	0.13	0.12

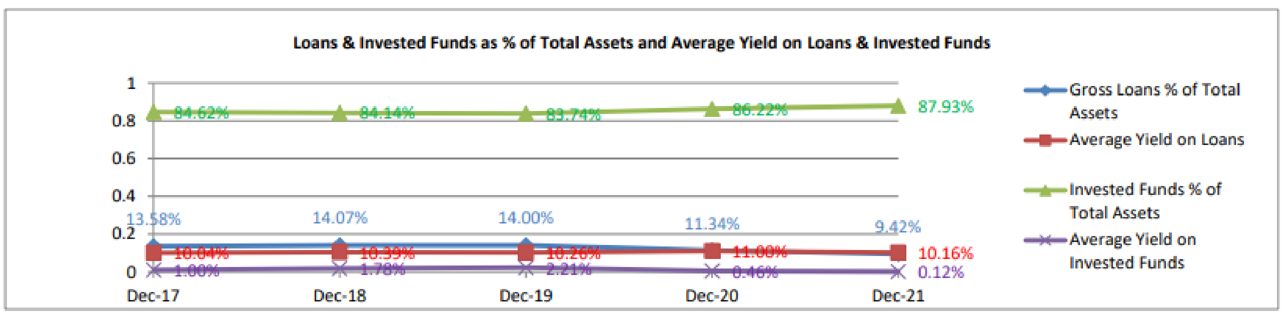
4th Quarter 2021 FSM Commercial Banking System Graphic Reports

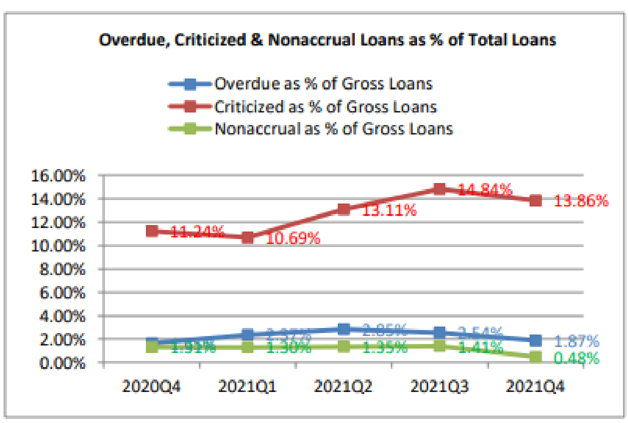


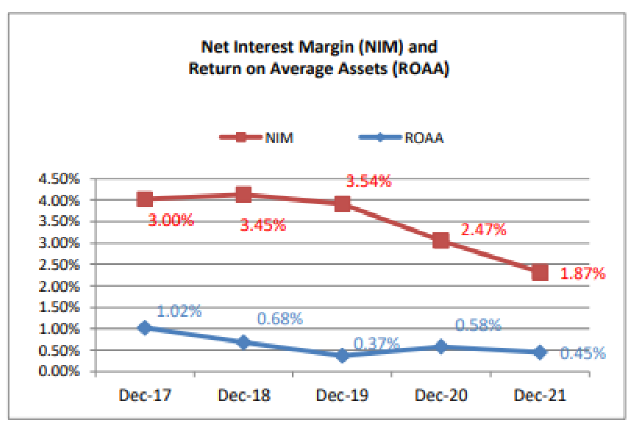




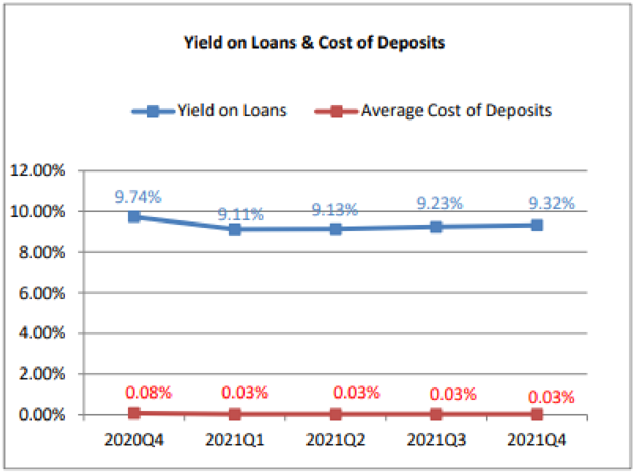


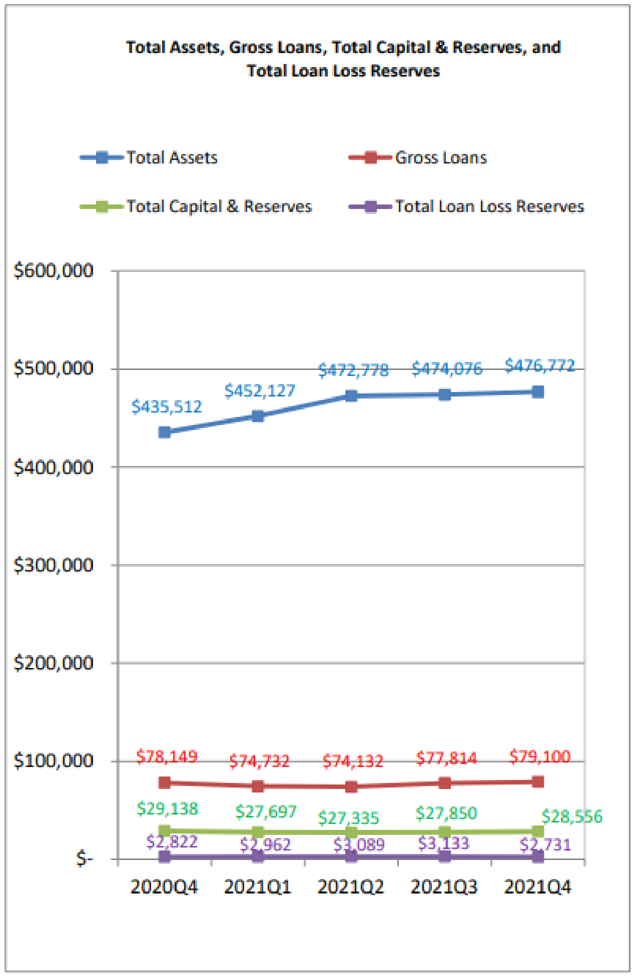


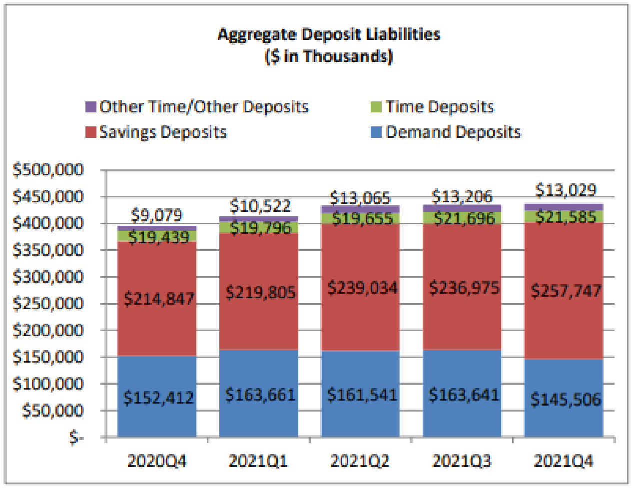




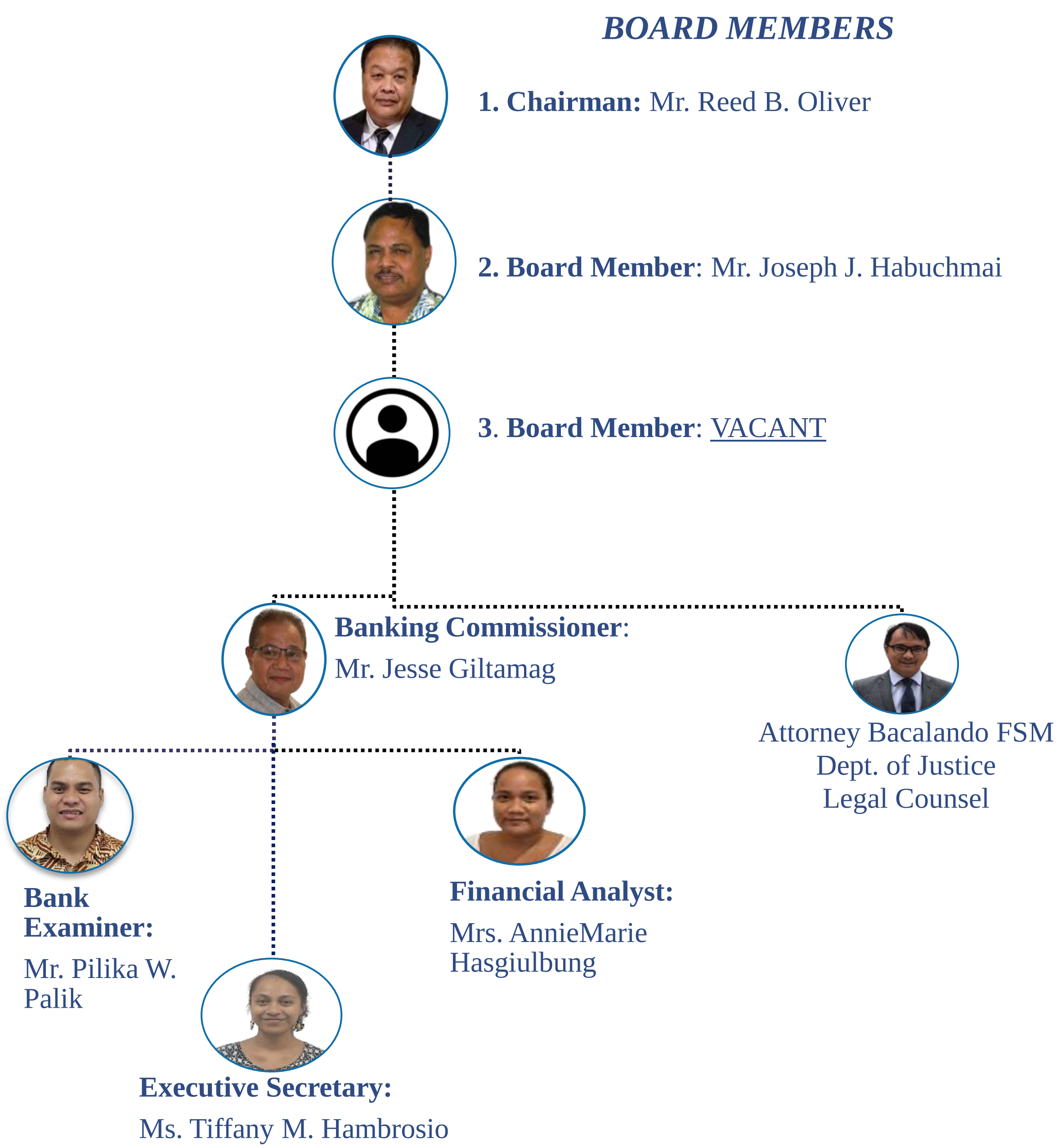
4th Quarter 2021 FSM Commercial Banking System Graphic Reports







Annex I: Organization Chart



Annex II: FDIC Statement

FDIC Statement on Financial Institutions Working with Customers Affected by the Coronavirus and Regulatory and Supervisory Assistance

The FDIC recognizes the potential for the Coronavirus Disease 2019 (referred to as COVID-19) to adversely affect the customers and operations of financial institutions. The FDIC understands that this unique and evolving situation could pose significant temporary business disruptions and challenges. The FDIC also recognizes that different communities are likely to be affected differently, and that financial institutions will need requisite flexibility to address the needs of their communities and customers. As such, the FDIC encourages financial institutions to work with all borrowers, especially borrowers from industry sectors particularly vulnerable to the volatility in the current economic environment, such as, but not limited to, airlines; energy companies; travel, tourism, and shipping industries; and small businesses and independent contractors that are reliant on affected industries. In addition, the FDIC encourages financial institutions to actively work with small businesses that have less financial flexibility to weather the near-term operational challenges, such as retail, restaurants, and local entertainment businesses, as well as hourly workers and independent contractors.

The FDIC will provide appropriate regulatory and supervisory assistance to affected financial institutions subject to its supervision. The FDIC encourages financial institutions to work with the FDIC regarding additional actions that may effectively manage or mitigate adverse impact on borrowers due to COVID-19.

Working with Customers: The FDIC encourages financial institutions to work with affected customers and communities. The FDIC recognizes that such efforts serve the long-term interests of communities and the financial system when conducted with appropriate management oversight and are consistent with safe and sound banking practices and applicable laws, including consumer protection laws. These efforts may include, but are not limited to:

- Waiving certain fees, such as:
  - Automated teller machine (ATM) fees for customers and non-customers,
  - Overdraft fees,
  - Late payment fees on credit cards and other loans, and
  - Early withdrawal penalties on time deposits;
- Increasing ATM daily cash withdrawal limits;
- Easing restrictions on cashing out-of-state and non-customer checks;
- Increasing credit card limits for creditworthy borrowers;
- Offering payment accommodations, such as allowing borrowers to defer or skip some payments or extending the payment due date, which would avoid delinquencies and negative credit bureau reporting; and
- Working with consumers who are temporarily unable to work due to temporary business closures, slowdowns, or sickness.

The FDIC recognizes there may be other accommodations that could assist customers and communities in responding to challenges from COVID-19. The FDIC supports and will not criticize efforts to accommodate customers in a safe and sound manner.

Lending: Financial institutions should work constructively with borrowers in communities and industries affected by COVID-19. The FDIC encourages financial institutions to engage in prudent and proactive actions, which are in the best interests of the financial institutions, the borrowers, and the economy. For example, when appropriate, a financial institution may modify or restructure a borrower's debt obligations due to temporary hardships resulting from COVID-19 related issues. Such cooperative efforts can ease cash flow pressures on affected borrowers allowing them to continue serving customers and paying employees and suppliers, improve their capacity to service debt, and facilitate the financial institution's ability to collect on its loans. In particular, these types of prudent arrangements for borrowers who operate small businesses can contribute to the well-being of local communities.

Modifications should be based on the facts and circumstances of each borrower and loan. Prudent efforts to modify the terms on existing loans for affected customers of FDIC-supervised banks will not be subject to examiner criticism. Modifications of existing loans should be evaluated to determine whether they represent troubled debt restructurings (TDRs). According to accounting standards, a modification triggers a TDR only if the institution grants a concession to the borrower which it would not otherwise grant because a borrower is experiencing financial difficulties. This could, for example, include extending the term of a loan for a borrower that otherwise meets the institution's underwriting standards, but is experiencing a temporary liquidity shortage due to COVID-19-related economic conditions.

Additionally, while a TDR designation means a modified loan is impaired for accounting purposes, it does not automatically result in an adverse classification. Many modified loans that are designated as a TDR for accounting purposes are fully performing and collectible credits. For this reason, examiners review the entirety of the lending relationship, including the duration of the borrower's cash flow, other assets, value of the collateral and other factors. FDIC examiners are directed to exercise significant flexibility in determining whether to adversely classify credits that are impacted by COVID-19, including those designated as TDRs.

Supervisory Relief: The FDIC will work with affected financial institutions to reduce burden when scheduling examinations, including making greater use of off-site reviews, consistent with applicable legal and regulatory requirements.

Regulatory Reporting Requirements: The FDIC's staff stands ready to work with financial institutions that may experience challenges fulfilling their reporting responsibilities, taking into account each financial institution's particular circumstances. The FDIC will not assess penalties or take other supervisory action against institutions that take reasonable and prudent steps to comply with regulatory reporting requirements if those institutions are unable to fully satisfy those requirements because of the effects of COVID-19.

Alternative Service Options for Customers: The FDIC understands that financial institutions may need to temporarily close a facility due to staffing challenges or to take precautionary measures. For example, some institutions may wish to limit foot traffic within a branch and provide services only through the drive-through lanes. The FDIC encourages financial institutions to reduce disruptions to their customers, provide alternative service options when practical, and reopen affected facilities when it is safe to do so. Affected financial institutions 3 are encouraged to notify their primary federal or state regulator and their customers of temporary closure of an institution's facilities and the availability of any alternative service options as soon as practical. In such case in which operational challenges persist, the FDIC, working with the state authority, will expedite, as appropriate, any request to operate temporary facilities to provide more convenient availability of services. In most cases, a telephone notice to the FDIC or state authority will suffice to start the approval process, with the necessary written notification being submitted shortly thereafter.

Annex III: Application for Banking License & Permit

APPLICATION PACKAGE FOR BANKING BUSINESS PERMIT

FEDERATED STATES OF MICRONESIA

BANKING BOARD/COMMISSION
FEDERATED STATES OF Micronesia
Townplaza Building, Suites #3 & 4
P.O. Box 1887
Kolonia, Pohnpei FM 96941
Phone: (691) 320-2015/2064, FAX: (691) 320-5433
Website: www.bankingboard.gov.fm

Annex IV: Fiscal Year 2021 Budget

The total appropriation for Fiscal Year 2021 for the FSM Banking Board was **$200,618,** the breakdowns on which below:

- **Personnel:** $114,843 was allocated for Personnel. Out of the total amount for Personnel, $14,305 was realized as not expended, due to time-lapse between resignation and hiring of replacement in personnel. One of the staff resigned to relocate to the US.
- **Travel:** $25,418 was allocated for domestic travel; no appropriation for international travel. $10,000 was reprogrammed to Consumables for office supplies, cyberspace meeting equipment, and COVID–19 related items. No domestic travel took place in FY'21 due to the pandemic.
- **Contractual Services:** $32,442 was allocated for contractual services of which $26,107.78 was expended.
- **Consumables:** $25,110 was allocated to consumables plus the $10,000 reprogrammed from Travel. $6,752.11 was realized as unexpended.
- **Fixed Assets:** $3,500 was allocated and no expenditure against it by end of the fiscal year.

From the total appropriation of **$200,618**, about $46,309.33 shown as unspent amount per internal records.

Chart 1: Approved amount for each Budget Category