2022 Annual Report

MISSION:

"Everything we do is driven by and revolving around the banking system 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."

Tel: 320-2015/2064

Town Plaza Suite Bldg. Kolonia, Pohnpei FM 96941

Website: *bankingboard.gov.fm*

TABLE OF CONTENTS

SUMMARY ASSESSMENT

Despite COVID-19 pandemic, inflation, among others, the overall condition of the FSM banking sector remained satisfactory for the year. Growth and stability still maintained.

- Total Assets of the banking system declined by $1,657 million from $476,772M to $475,115M or -0.3% 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 remains low at 0.48%, same for the previous year. The volume of outstanding loans increased by $6.5M or 8.2%. Provisions for Bad Loans to mitigate against potential losses remain more than adequate at $3.511M for the year compared to $2.731M in 2021 which is about eight times the sector's volume of NPLs.

- Consumer lending improved from $34,939M to $36.129M. Commercial lending also improved from $44,161M to $49,455M. Overall, lending increased by $6,484M. Deposits on the other hand decreased from $437,867M to $435.912M, due primarily to decline in savings, time and other deposits. However, demand deposits increase by $12.5M. Demand deposits constitutes 53% of the total Deposits.

- Return on Assets increased from 0.70% to 1.59% over the year, primarily due to the improvement in yields on the excess liquidity placed abroad in US deposits and investments. returns due to global economic circumstances.

- Banking system remains highly liquid $371,294M or eighty percent (80%) of the sector's $475,115M total assets are liquid assets which are placed or invested abroad.

- In aggregate, approximately$379.156M of the sector's$475.115M 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 for year end 2022 was reported at $56,761.72 of which $600.00 was deducted by the regulated banks for publication fees. As of date of this report, the remaining balance is $56,161.72.

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

- The banking system relaxed its related COVID-19 pandemic measures, especially in the customer service strategies in the later part of the year as more people in the FSM received vaccination. While the banking system instituted a voluntary loan repayment or deferment program to help the community with pandemic financial difficulties, reports received showed borrowers did not apply or opt for the program.

- Of particular potential challenge before banking sector, thus the community, is the expiration of Article XI of the renewed Compact, i.e., the FDIC deposit insurance coverage and accompanying technical assistance, including but not limited to yearly on-site financial and consumer protection examinations. The insurance coverage and technical assistance have indeed instilled confidence and helped with safety, soundness and stability in the banking system.

- Net income realized for the year ended 2022 was $7.5M. Average net income over the past five years is reported at $9.4M.

NEW DEVELOPMENTS

The financial stability of our banking system is directly linked to both the domestic and global economic and technological circumstances.

Covid-19 Pandemic:

The operational risk on the banking system due to the COVID-19 declined as the result of increased vaccination among the general public. For example, the regular hours of the banks restored back to that prior of COVID-19 pandemic. COVID-19 finally reached FSM's shore in mid-year 2022. By this time, the banking system already instituted the necessary safeguards and mechanisms to better cope and weather through the outbreak.

Economic Impact Payments (EIPs):

The banking system received EIPs from the US Treasury via electronic transfer or paper check, in addition to remittance from abroad and FSM Government monetary assistance, which contributed to the increased in deposits, resulting in loan-to-deposit ratio of eighteen (18) percent.

Climate Change:

Climate change has implications on the banking system. It remains as an issue before the banking system, domestically and internationally. 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 continued to engage 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 staff participated in several meetings by IMF, World Bank and other central bank authorities. These meetings are meant to raise awareness on the implications of climate change on the banking system.

The Legal tender in the FSM is the US Currency.

Cryptocurrency:

The legal tender in the FSM is the US Currency. However, cryptocurrency has surfaced and been accepted in other parts of the world as a substitute or an 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 or digital or virtual assets, 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 Cooperation's:

The Board has in place established mutual cooperation arrangements with recognized regulatory and supervisory authorities in the region, US and other international authorities. 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 2022, including FDIC Examination School Classes did not take place.

FDIC was contacted to provide training information when resumed. The Banking Commissioner, Banking Examination and Banking Financial Analyst had been 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 offer 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 and trainings 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 2022 (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 took place in December 2022 after two years without any meetings due to the pandemic. Sensitive and myriad of information 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. Because of the pandemic and border closure, these examinations were conducted virtually. The Commissioner and staff took part in the examinations. However, in the interest of capacity building, it is proven more effective for the staff to participate in person in these examinations.

With the reopening of the border, it is expected the on-site examination will take place in-person in 2023. The FSM domestic bank is expected to continue to maintain a better CAMELS rating in the financial examinations. The Bank remains highly capitalized. Building capital position of the Bank is encouraged through retained earnings.

Consumer Compliance Examinations also conducted. The Bank performance in this respect remains satisfactory.

Off-site monitoring, review and evaluation were enhanced and conducted as a core routine activity for assessing performance, soundness, safety and stability of the banks.

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

Prior to the COVID-19 outbreak, 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 with emphasis on risk-based framework, 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 outbreak. During the AFSPC Annual Meeting in December 2022, discussion took place for phases 2 and 3 of the TA in 2023. 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. Other technical assistance required, including but not limited updating the Call Report and its instruction, and the Board will request IMF and/or other known international banking regulatory/supervisory authorities to assist.

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 FSI TA recommended improvement in the CALL Report template to strengthen reporting and collection of key data for allowing thorough assessment on safety, soundness and stability. The CALL Report TA is expected in 2023.

AML/CFT:

AML and CFT are important aspects for ensuring safety, soundness and stability of the banking system. As such, the Board has been exploring opportunities to improve its capacity in these areas, including ACAM, IMF, STI and others.

Banking Permit/License Applications:

There were two queries into obtaining a permit and license to engage in banking business in the FSM. One of the inquirers was a citizen of the FSM, who was made aware of and provided the application form; however, he had not filed the application.

The other inquirer was a digital asset trading and settlement business, BAM Trading Services, Inc. BAM as a digital asset trading and settlement platform business allows users to purchase digital assets from, and sell digital assets to, other users. After background and virtual meetings with BAM, BAM was advised of the US Dollar as the legal tender in the FSM and that its business might not fall under 29FSMC. The Board learned that BAM was issued a Certificate of Good Standing by the FSM Department of Justice.

IMF Article IV Mission:

Usually every year, the IMF Article IV Mission would meet with the Board to discuss overall performance of the banking system. There was no Article IV Mission in 2022 due to the pandemic and border closure.

Annual AFSPC Meeting:

The 2022annualmeetingsof the Association of Financial Supervisors of Pacific Island Countries (AFSPC) were held in December in Nadi, Fiji, after PNG decided not to host in PNG due to outbreak of COVID-19. The general consensus was for the FSM host in either 2024 or 2025. Each member country made presentation on the overall status of the respective banking system in each country. The Banking Commissioner and Bank Examiner attended and made presentation on the overview status of the FSM Banking system. RMI, Palau and FSM requested through PFTAC for a TA to form the North Pacific Supervisory College and review and improve the risk-based frameworks for each country.

Website:

The Board continued to post and update information on its website, including but not limited to quarterly financials: www.bankingboard.gov.fm.

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 expired 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 2022; 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.

Section 202 of the Act stipulates the principal purposes of the Board which are, generally:

- 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.

In view of the above general mandates, the Board as the supervisory entity is charged with especially the micro prudential 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 minimizes 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 micro prudential 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 2022 was 14.33%for consumer loans and 4.75% 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 2022 was 130. The system realizes a net income of $7.5M compared to $3.269M in 2021.

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 overseeing the works of other staff, including but not limited to monthly, quarterly and annual analyses of individual bank and sector-wide financial returns, collection 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.

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. This includes 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.

There was no turnover in staff in 2022.

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 2022, Congress appropriated $208,877 to cover personnel, travel, contractual services, consumable, and fixed assets. Board's internal reconciliation records show an unexpended amount of about $48,523.33 at year-end. No domestic or international travel took place due to the pandemic and border closure. 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, and expenditures.

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 FSM Codes.

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 2022 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.

Issues and Challenges

The Federal Programs and Services Agreement under the renewed Compact of Free Association between the FSM and US will expire in September 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 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 borrower's 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

The FSM commercial banking system remained solvent and viable in 2022 with adequate capital and high liquidity despite the ongoing economic challenges. After experiencing slowdown in earnings growth and slight diminution in capital during the pandemic period, the banks' financials have improved and rebounded to pre-pandemic levels as of December 31, 2022. The banking system remained sound and financial stability risks appeared generally contained during the year.

The Balance Sheet of the FSM commercial banking system reported combined assets at $475.1 million as of December 31, 2022, a decrease over the year by $1.7 million (-0.3%). The compositions of total resources of the system at year end 2022 are broken down as follows:

	US $ In Thousands	Percentage
Liquid Assets (Cash & Due from Abroad)	$379,156.00	80%
Loan Portfolio	$85,584.00	18%
Bank Premises and Other Assets	$10,375.00	2%
	$475,115.00	**100%**

Total Liquid Assets stood at $379.2 million and comprised 80% of the system's total assets, a decrease from $387.5 million, however unchanged from 80% compared to end-December 2021. Liquid Assets consist of *Cash* and *Foreign Assets/Due from Banks & Others Abroad*. As of the quarter ended December 31, 2022, *Cash* was at $7.9 million while *Due from Abroad* was at $371.3 million.

Total Loans increased over the year by $6.5 million (8.2%) to $85.6 million. Commercial lending increased over the year by $5.3 million (12.0%) to $49.5 million. Consumer lending increased over the year by $1.2 million (3.4%) to $36.1 million. The loan portfolio comprised 18.0% of the system's total assets, with commercial loans composing 57.8% of the lending portfolio while consumer lending constitutes 42.2%.

On the liabilities side, **Total Deposits** decreased over the year by $1.9 million (-0.4%) to $435.9 million. Total deposits comprised 91.7% of the system's total liabilities and equity. The system's deposit base structure was significantly dominated by Savings deposit facilities at $252.4 million (57.9%), followed by Demand Deposits at $158.0 million (36.3%), Time Certificates of Deposits (TCDs) at $19.6 million (4.5%), with the remaining $5.9 million (1.3%) for other deposit facilities.

Total Loan to Deposit ratio for the system stood at 19.63%. The ratio increased compared to 18.06% in the same period of 2021.

<u>Operating Highlights:</u>

- **Total interest income** at year end 2022 was reported at $13.4 million, an increase from $8.5 million at year end 2021. The **net interest margin** (net interest income/average earning assets) increased by 104 basis points over the year to 2.91%. The bank reported **prevailing interest rates** on consumer and commercial loans at 14.33% and 4.75% respectively. Compared to a year ago, they were 13.83% for consumer loans and 4.70% for commercial loans. The **average yield on loans plus invested funds** increased from 1.94% at end-December 2021 to 3.04% at end-December 2022.

- **Total Income** was recorded at $15.5 million, an increase compared to $10.3 million in the previous year. **Total Year-to-Date Expenses** (excluding taxes of $397 thousand) were at $8.0 million. The banks ended 2022 with $7.9 million in **Net Operating Income**. The Return on Average Assets (ROAA), net income as a percentage of average assets, improved from 0.70% at end-December 2021 to 1.59% at end-December 2022.

- The **efficiency ratio**, overheads to earnings after deducting interest expense, shows how much each dollar of income is consumed by the banks' operating costs. The efficiency ratio for the system at quarter ended December 31, 2022 was at 43.3%, a decrease when compared to 61.9% in the same period of 2021.

- Reported **asset quality** showed improvement during the year as **criticized loans as a percentage of total loans** decreased from 13.08% at year-end 2021 to 8.15% at year-end 2022. Although **overdue loans as a percentage of total loans** slightly increased from 1.87% in 2021 to 1.88% in 2022, it remained moderately low. **Non-accrual loans as a percentage of total loans** remained unchanged at 0.48% at end December 2022 compared to the same period of the prior year. Total **Loan loss reserve** of the banks stood at $3.5 million as at December 31, 2022, an increase from $2.7 million in the prior year. The consolidated reserve amount the banks are required to maintain at year end 2022 was $248 thousand. The amount of loan loss reserve kept by the bank at the end of the year was 11 times greater than their required reserve amount. The banks reported a year-to-date charge-off of $1.2 million, an increase compared to $981 thousand in the previous year. Total recoveries as at end-December 2022 was $441 thousand, compared to $405 thousand in the prior year.

- The banks held **total capital and reserves** at $26.580 million as of December 31, 2022, a slight increase by $22 thousand from $26.558 million in the same period of 2021.

The banking system's overall performance was assessed as satisfactory as of December 31, 2022, based on the banks' satisfactory levels of capital, earnings, liquidity and strong asset quality indicators as of December 31, 2022.

Capital Adequacy Indicators

- ❖ **The banks remain well-capitalized.** Total capital and reserves for the system stood at $26.580 million as of December 31, 2022.

- ❖ 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, 2022, 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 2022 Annual Report, the Bank's aggregate statutory capital exceeded the FDIC's well capitalized standards.

Asset Quality Indicators

- Asset quality remains satisfactory. Although total assets decreased over the year by $1.7 million (-0.3%), the asset base remains high and strong. The decrease in total assets over the year was a result of the aggregate $8.4 million decline in Liquid Assets during the year.

- Foreign Assets/Due from Banks & Others Abroad comprise78.2%ofthesystem'sTotalAssets. Of the $379.2 million in Liquid Assets, $301.1 million are placed in interest bearing deposits with U.S. FDIC insured banks, $61.6 million are invested in U.S. Government securities (solely available for sale and guaranteed by the U.S. Government) and $8.5 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 2022 was 0.63%, up from 0.43% in 2021.

- **The quality of the system's loan portfolio is satisfactory.** The ratio of Non-Performing Loans to Total Loans was nominal at 0.48%; it remained unchanged from 0.48% a year ago. Outstanding Non-Performing Loans fell by 8.7%, or $33 thousand to $414 thousand as at year-end 2022. Gross Loans increased over the year by $6.5million (8.2%); commercial loans increased over the year by $5.3 million (12.0%) and consumer loans increased by $1.2 million(3.4%).

- **Loan Loss Reserves is sufficient**. The current level of loss allowance as of December 31, 2022, is over eight 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, 2022, the level of loss allowance stood at $3.5 million, well above Banking Board's minimum and recommended level. The banks had reported a year-to-date charge-off of $1.2 million against recoveries of $441 thousand.

- Criticized loans consist of Special Mention, Substandard, Doubtful and Loss Loans. Special Mention loans decreased from $9.9 million in 2021 to $5.0 million in 2022. The particular category of loans increased substantially during the pandemic in 2020 and 2021 due to the probability of credit default or the likelihood that borrowers will fail to pay back their loans. Substandard loans increased from $801 thousand in the prior year to $1.2 million; Doubtful loans decreased over the year from $180 thousand to $12 thousand; and Loss loans decreased from $29 thousand to nil at year end 2022. The Banking Board continues to closely monitor and ensure the banks have sound credit risk assessment and measurement process to assess credit risk and account for expected credit losses.

Earnings Performance Indicator

- **Earnings performance for the banks is satisfactory.** The banks income performance has substantially improved as their net income have returned to pre-pandemic levels at year end December 2019.

- The Banks managed to end year 2022 with $3.6 million in Net Operating Income owing to the improvement in interest income over the year and the managed levels of interest costs and provisioning for bad loans. Banks have regained their pre-covid earnings levels with improved net interest income and expense levels commensurate with prior year levels.

- The system generated Net Income of $7.5 million for the period ended December 31, 2022, up from $3.3 million at year-end 2021. Total Interest Income has increased by $4.9 million to $13.4 million. Stable profitability is expected for the system and there continues to be potential for further lending growth given sustained excess liquidity.

- Total Income was recorded at $15.5 million, an increase from $10.3 million at year-end 2021., Total interest income improved over the year as total loans grew by $6.5 million and yield on loans and investments abroad improved from 1.94% in 2021 to 3.04% in 2022.

- Total Year-To-Date Expenses (excluding taxes of $397 thousand) was about $8.0 million, a drop by $1.2 million from $6.8 million a year ago.

- Return on Average Assets/ROAA (net income as a percentage of average assets) has increased from 0.70% in the prior year to 1.59%—the increase is proportionate with the improvement in net income and slight decrease in average total assets.

- 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 increase is mainly due to the improvements in average yield on loans and investments.

FSM Banking System

Consolidated Income and Expense Statement (5 Years)

(inU.S.'000s)	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22
Interest Income	12,537	13,451	9,956	8,520	13,444
Interest Expense	523	592	296	119	314
NETINTERESTINCOME	**12,014**	**12,859**	**9,660**	**8,401**	**13,130**
Provisions For Bad Loans Expense	**621**	**542**	**998**	**330**	**910**
NON-INTERESTINCOME	**1,799**	**1,991**	**1,690**	**1,801**	**2,419**
NON-INTERESTEXPENSE	**6,574**	**6,677**	**6,307**	**6,312**	**6,736**
Net Operating Income	6,618	7,631	4,045	3,560	7,903
Less: Taxes	301	295	239	291	397
Net Income	**6,317**	**7,336**	**3,806**	**3,269**	**7,506**

Liquidity Indicators

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

- Total Liquid Assets stood at $379.2 million and made up 86.98% of Total Deposits as of December 31, 2022. The ratio declined from 88.51% in 2021. This means that for every dollar in deposit liabilities, the banking system maintained about 87 cents in liquid assets.

- Even though local liquid assets (i.e., cash balances) aggregated for both banks cover just 2.07% of Total Liquid Assets, onsite engagements with the banks supplemented with transmitted 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.**

- Total Deposits of the system decreased over the year by $2.0 million (-0.4%) to $435.9 million.

- The ratio of Total Loans to Total Deposits increased from 18% in 2021 to 20% in 2022, commensurate with the reported increase in loans over the year while deposits slightly decreased. The current ratio means that on average out of every dollar received by the banks, about 20 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 2022, there were 29,755 deposit accounts at the commercial banks; of which 2,675 belong to Small Medium Enterprise (SME) accounts and 26,448 belong to household sector accounts. The total number of deposit accounts increased when compared to 21,214 at year end 2021. The increase was due to both increases in household accounts by 7,182 and SMEs by 1,231. Outstanding deposits at year end 2022 were $435.9 million; of which $134.8 million are in SME accounts and $96.0 million are in household accounts. Deposit amounts decreased compared to $437.9 million in 2021. Both banks may have decreased in both the number of accounts and the outstanding deposit amounts during the year.

- The number of loan accounts at year end 2022 was 7,608; of which 106 belong to SMEs and 7,383 belong to household. Number of loans decreased from 8,047 in 2021. Outstanding loans stood at $85.6 million; of which $11.4 million are issued to SMEs and $35.9 million to households. During the year, the total balance in loans increased by $6.6 million from $79.0 million in 2021.

Key Performance Indicators

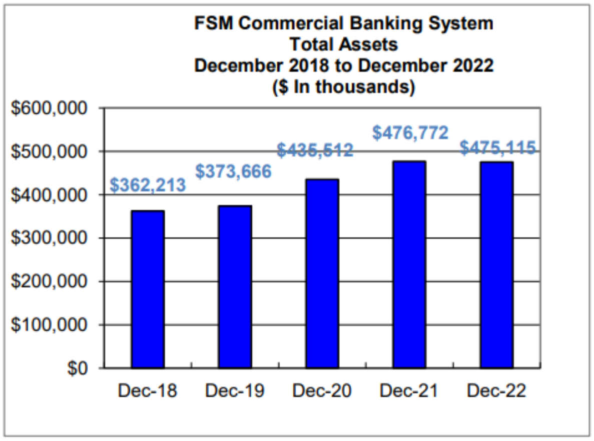
KEY RATIOS (%)	December 31, 2021	December 31, 2022
Balance Sheet Ratios:		
Liquid Assets % of Deposits	88.51%	86.98%
Total Loans % of Total Deposits	18.06%	19.63%
Consumer Loans % of Total Loans	44.17%	42.21%
Commercial Loans % of Total Loans	55.83%	57.79%
Invested Funds % of Total Deposits	86.68%	85.18%
Invested Funds % of Total Assets	79.61%	78.15%
Liquid Assets % of Total Assets	81.28%	79.80%
Asset Quality Ratios:		
Overdue Loans as % of Total Loans	1.87%	1.88%
Criticized Loans as % of Total Loans	13.80%	8.15%
Non-Accrual Loans as % of Total Loans	0.48%	0.48%
Loss Reserves as % of Total Loans	3.45%	4.10%
Provisions as % of Total Loans	0.42%	1.06%
Classified as % of Total Loans	13.80%	8.15%
Classified Consumer % of Total Consumer	3.01%	2.36%
Classified Commercial % of Total Commercial	22.33%	10.74%
Interest Measures:		
Average Yield on Loans	9.32%	9.24%
Average Yield on Invested Funds	0.43%	1.63%
Average Cost of Deposits	0.03%	0.07%
Interest Spread (Yield -Cost)	1.90%	3.00%
Net Income to Average Assets (ROAA)	0.70%	1.59%
Net Int Inc to Avg Earning Assets (NIM)	1.87%	2.91%

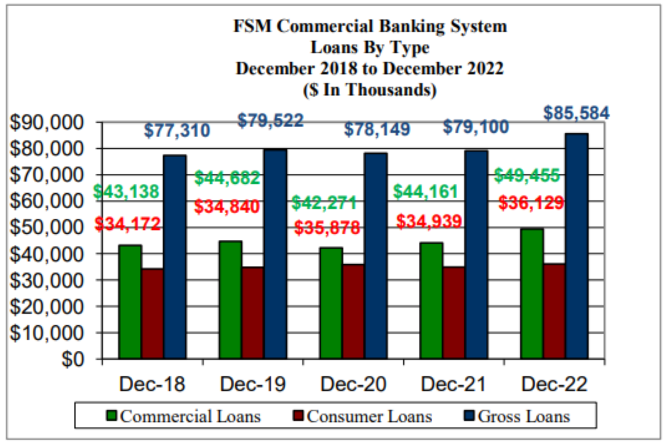
FINANCIAL SOUNDNESS INDICATORS

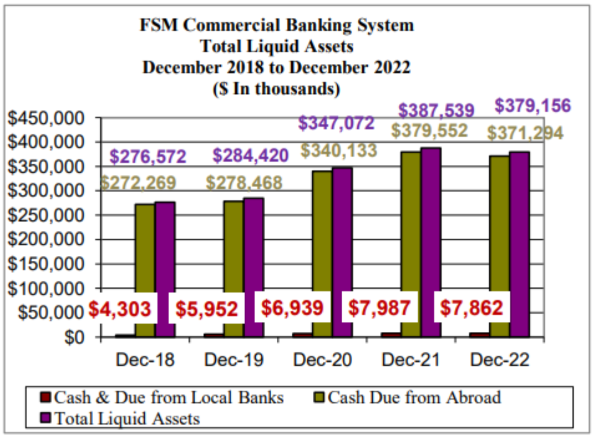
Financial Soundness Indicators (Core)	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22
Capital-based					
Regulatory capital to risk-weighted assets	33.27	35.24	37.57	37.24	38.48
Regulatory Tier 1 capital to risk-weighted assets	33.27	35.24	37.57	37.24	38.48
Non-performing loans net of provisions to capital	3.25	1.93	1.05	2.90	3.72
Asset Quality					
Non-performing loans to total gross loans	1.21	1.25	0.60	1.28	1.39
Sectoral distribution of loans to total loans:					
Residents	66.52	65.86	65.32	68.16	63.79
Interbank loans	-	-	-	-	-
Other financial corporations	-	-	-	-	-
Non-financial corporations	59.68	59.51	59.24	62.88	56.66
Other domestic sectors	6.83	6.34	6.07	5.28	7.13
Non-residents	33.48	34.14	34.68	31.84	36.21
Earnings and Profitability					
Return on assets	1.80	1.98	0.91	0.70	3.29
Return on equity	25.59	26.23	13.29	11.71	59.05
Interest margin to gross loans	86.98	86.59	85.12	82.35	84.45
Noninterest margin to gross income	86.98	86.59	85.12	82.35	84.45
Liquidity					
Liquid assets to total assets	61.12	62.24	58.53	67.35	60.39

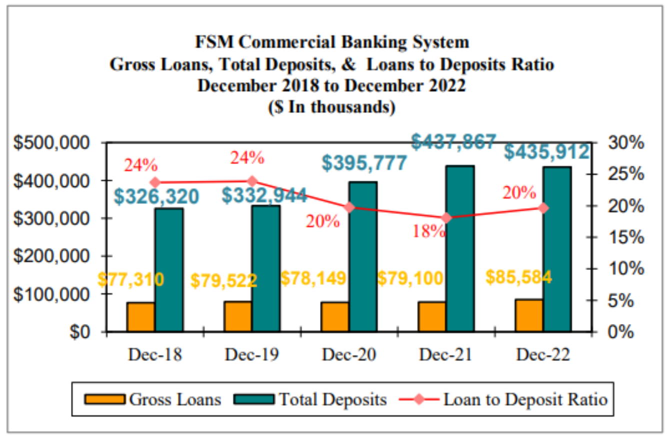
Financial Soundness Indicators (Encouraged)	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22
Capital to assets	6.02	6.11	5.59	5.34	5.55
Customer deposits to total (non-interbank) loans	422.09	418.68	506.44	553.56	493.73
Personnel expenses to non-interest expenses	45.57	45.88	51.80	50.16	48.69
Foreign-currency-denominated loans to total loans	0.00	0.16	0.13	0.12	0.12

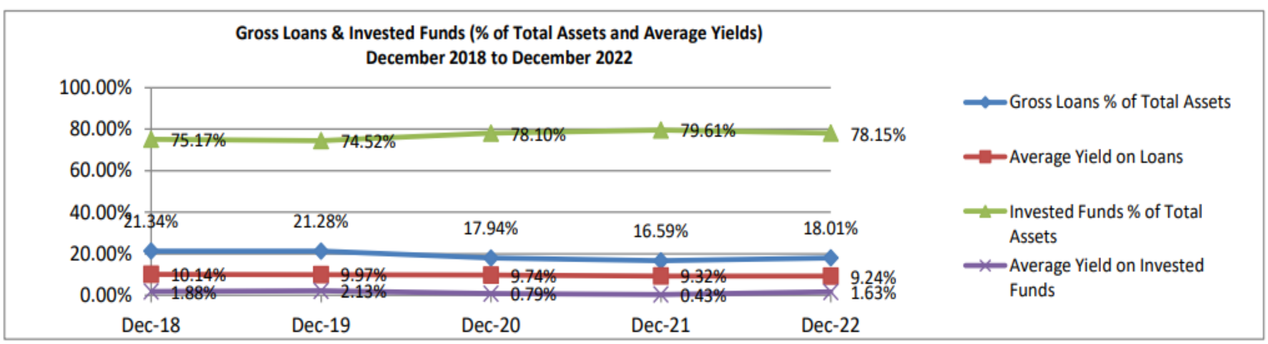
4th Quarter 2022 FSM Commercial Banking System Graphic Reports

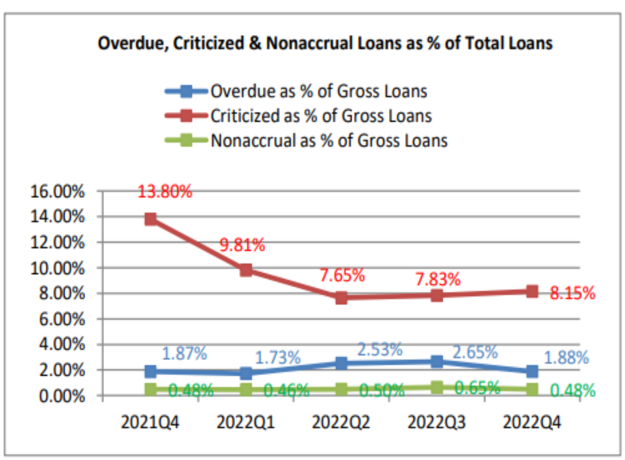


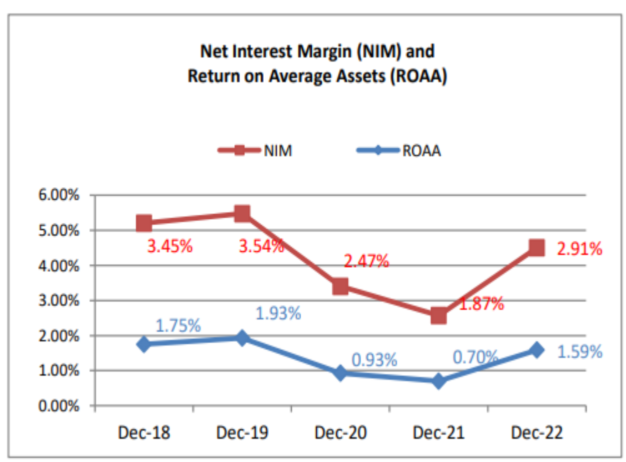




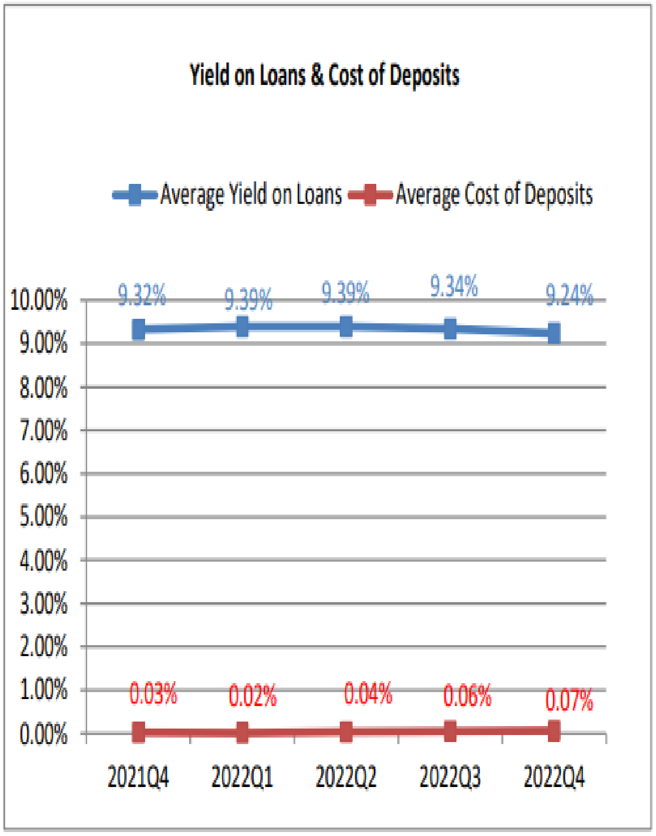


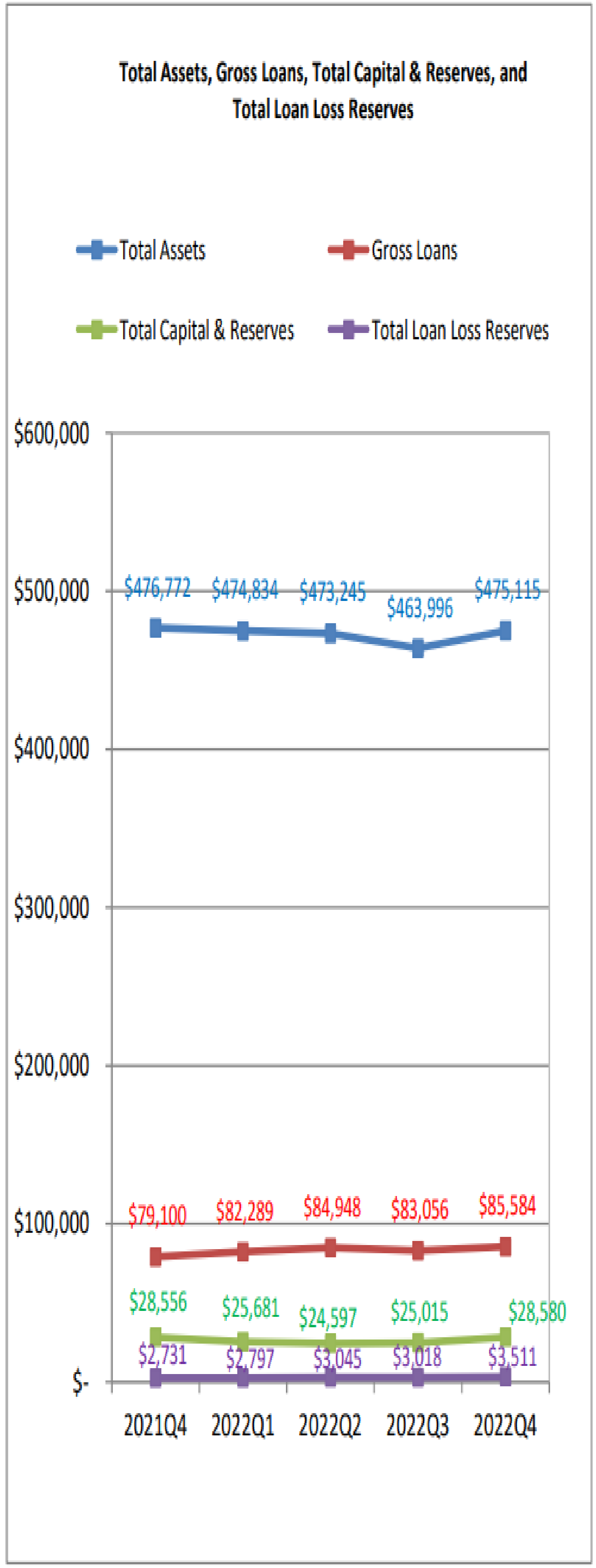


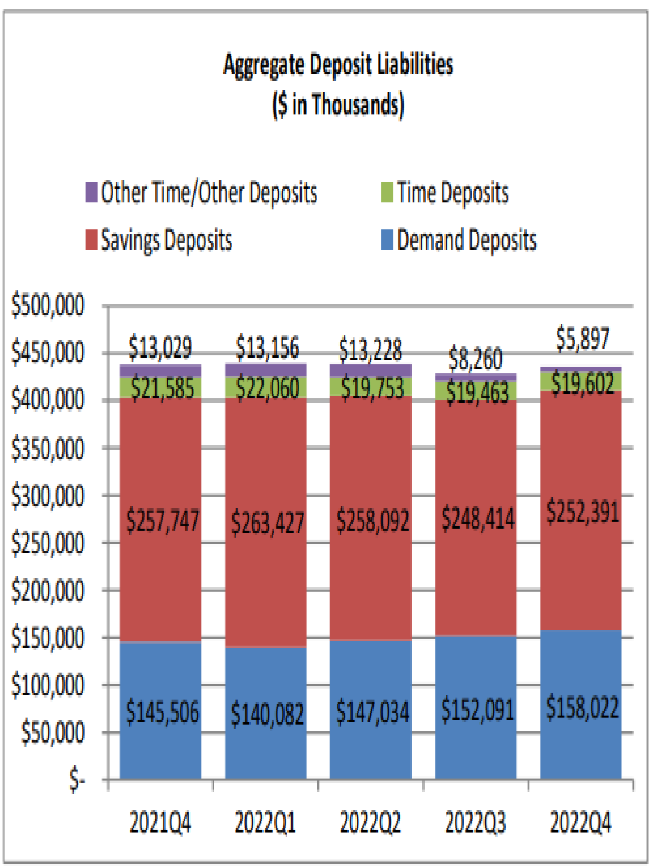




4th Quarter 2022 FSM Commercial Banking System Graphic Reports







Annex I: Organization Chart

ORGANIZATION OF FSM BANKING BOARD

BOARD MEMBERS

Chairman: Mr. Reed B. Oliver
Member: Mr. Joseph J. Habuchmai
Member: Vacant

BANKING COMMISSIONER

Mr. Jesse Giltamag

LEGAL COUNSEL/ASST. ATTORNEY GEN.

Mr. Leonito Bacalando Jr.

ADMINISTRATIVE OFFICER

Ms. Tiffany Hambrosio

BANK EXAMINER

Mr. Pilika Palik

FINANCIAL ANALYST

Mrs. AnnieMarie Hasgiulbung

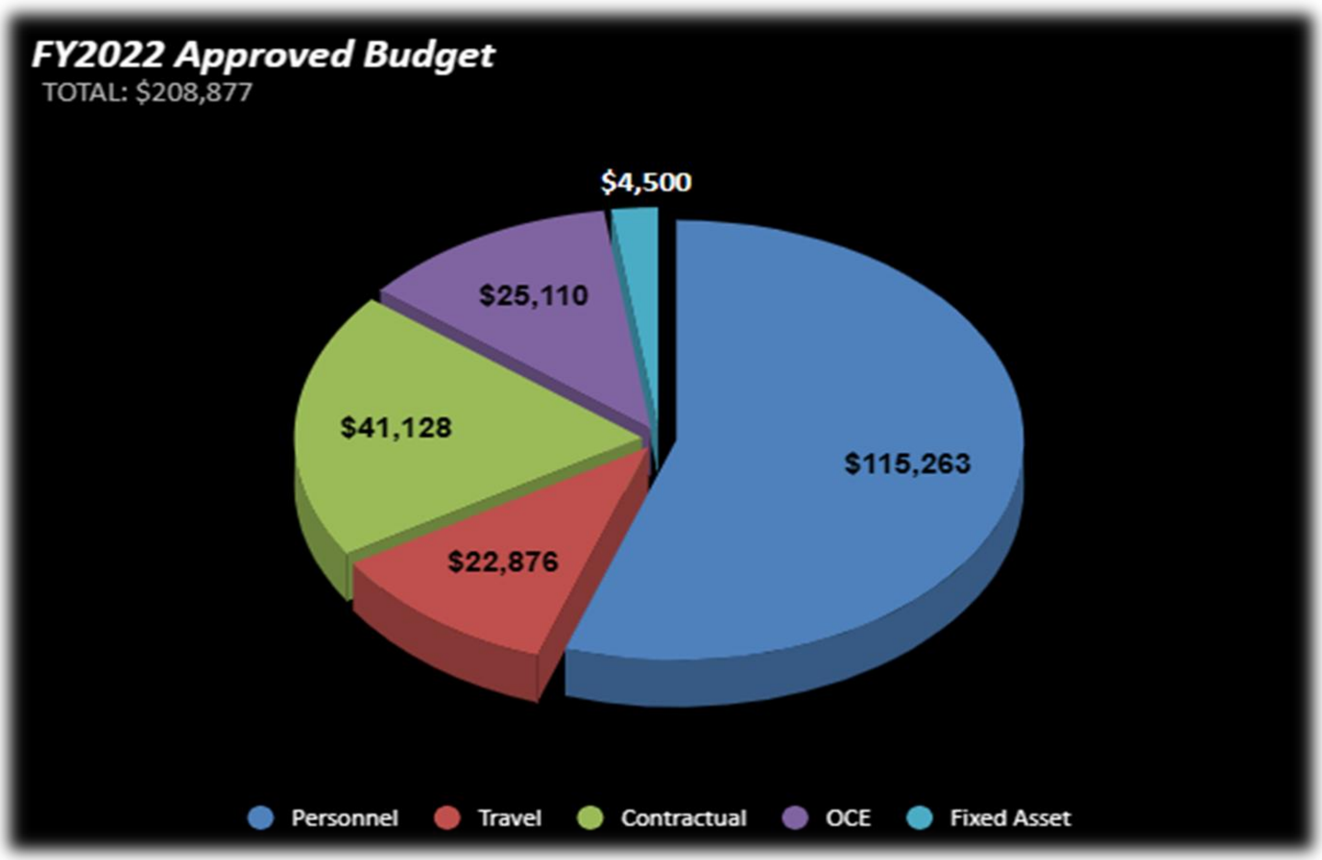
Annex II: Fiscal Year 2022 Budget

The total appropriation for Fiscal Year 2022 for the FSM Banking Board was **$208,877,** the breakdowns on which below:

- **Personnel:** $115,263 was allocated for Personnel and was exhausted out.
- **Travel:** $22,877 was allocated for domestic travel; no appropriation for international travel. No domestic travel took place in FY'22 due to the pandemic.
- **Contractual Services:** $41,128 was allocated for contractual services of which $22,174.44 was expended.
- **Consumables:** $25,110 was allocated to consumables plus the $3,500 reprogrammed from Fixed Assets. $5,693.77 was realized as unexpended.
- **Fixed Assets:** $4,500 was allocated and $3,500 was reprogrammed into Consumables for 8 Conference Chairs for Banking Board and $1,000 was realized as unexpended.

From the total appropriation of **$208,877**, about $48,523.33 shown as unspent amount per internal records.

Chart 1: Approved amount for each Budget Category



Annex III: Balance Sheet: December 31, 2022

FSM COMMERCIAL BANKING SYSTEM
BALANCE SHEET
December 31, 2022

(US$ In Thousands)	31-Dec-22	%	31-Dec-21	%	Yearly Variance	% Change	30-Sep-22	%	Quarterly Variance	% Change
ASSETS										
Cash & Due from Local Banks	7,862	2%	7,987	2%	(125)	-1.6%	11,810	3%	(3,948)	-33.4%
Foreign Assets/Due from Banks & Others Abroad	371,294	78%	379,552	80%	(8,258)	-2.2%	359,073	77%	12,221	3.4%
Total Liquid Assets	**379,156**	80%	**387,539**	81%	(8,383)	-2.2%	**370,883**	80%	8,273	2.2%
Loans					-				-	
Commercial	49,455	10%	44,161	9%	5,294	12.0%	47,987	10%	1,468	3.1%
Consumer	36,129	8%	34,939	7%	1,190	3.4%	35,069	8%	1,060	3.0%
Total Loans	**85,584**	18%	**79,100**	17%	6,484	8.2%	**83,056**	18%	2,528	3.0%
Other Assets	10,375	2%	10,133	2%	242	2.4%	10,057	2%	318	3.2%
Total Assets	**475,115**	100%	**476,772**	100%	(1,657)	-0.3%	**463,996**	100%	11,119	2.4%
LIABILITIES & CAPITAL										
Deposits										
Demand	158,022	33%	145,506	31%	12,516	8.6%	152,091	33%	5,931	3.9%
Savings	252,391	53%	257,747	54%	(5,356)	-2.1%	248,414	54%	3,977	1.6%
Time	19,602	4%	21,585	5%	(1,983)	-9.2%	19,463	4%	139	0.7%
Other Time/Other Deposits	5,897	1%	13,029	3%	(7,132)	-54.7%	8,260	2%	(2,363)	-28.6%
Total Deposits	**435,912**	**92%**	**437,867**	92%	(1,955)	-0.4%	**428,228**	92%	7,684	1.8%
Other Liabilities & Capital 1/	39,203	8%	38,905	8%	298	0.8%	35,768	8%	3,435	9.6%
Total Liabilities & Capital	**475,115**	100%	**476,772**	100%	(1,657)	-0.3%	**463,996**	100%	11,119	2.4%
Memorandum Items:										
Loan/Deposit Ratio (%)	20%		18%				19%			
Consumer Loans (% of total loans)	42%		44%				42%			
Commercial Loans (% of total loans)	58%		56%				58%			

Footnote:

1/ Includes loan loss reserves

Source: FSM Banking Board