2023 Annual Report

MISSION:

"Everything we do is driven by and revolving around the soundness, safety and stability of the banking system."

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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TABLE OF CONTENTS

SUMMARY ASSESSMENT

The overall condition of the FSM commercial banking sector remained satisfactory for the year, December 31, 2022 – December 31, 2023. Growth and stability still maintained.

- Total Assets of the banking system increased by $2.001M from $475.115M to $477.166M.

- Asset quality for the banking system for the year remains satisfactory. The industry ratio of Non-Performing Loans (NPLs) to Total Loans stood at 1.57% at year end, compared to 0.48%for same period in 2022. The volume of outstanding loans decreased from 8.2% to 2.55%. However, provisions for Bad Loans to mitigate against potential losses remain more than adequate at $2.5M which is about nine times the sector's volume of NPLs.

- Consumer lending decreased from $36.129M to $35.996M. Commercial lending also decreased from $49,455M to $48.019M. Deposits decreased from $435,912M to $424.449M, primarily due to declines in savings, time and other deposits. Demand deposits constitutes .40%, while Savings deposits represent .56% of the total Deposits.

- Return on Assets increased from 1.59% to 3.34% over the year, primarily due to the improvement in yields on the excess liquidity placed abroad in US deposits and investments. For example, invested funds as percentage of total assets is roughly 78.32% over the year.

- Banking system remains highly liquid, $374.532M or eighty percent (80%) of the sector's $477.166M total assets are liquid assets which are placed or invested abroad.

- In aggregate, approximately$381.592M of the sector's $477.166M 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 and retained earnings maintained well above the required minimum capital threshold.

- Escheatment for year- end 2023 was reported at $18,177.80 of which $347.50 was deducted by the regulated banks for publication fees. The total payments to FSM Finance for year 2023 was $17,830.25.

- 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 or maintain capital for its branch operations in the FSM. However, the bank is required to maintain required level of capital by its home jurisdiction.

- Of particular potential challenge before banking sector, thus the community, was the expiration of Article XI of the renewed Compact, i.e., the FDIC deposit insurance coverage and accompanying technical assistance and 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. With Compact III in effect, this overarching risk is no longer an issue to the FSM banking system.

- Net income realized for the year ended 2023 was $16M. Average net income over the past five years is reported at $7.6M.

NEW DEVELOPMENTS

Similar to other banking system in other countries, the financial stability of FSM banking system is directly linked to both the domestic and global economic and technological circumstances.

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 continues 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.

The Board continues to explore with DECEM possible financing mechanism, whereby Climate Fund could be established as seed funding either on a grant or guaranteed basis with minimal interest rate for borrowers who incorporate climate change mitigation strategies in their portfolios, 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 challenges or impacts, 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 challenges and impacts on the banking system and possible remedial solutions.

Introduction of Basel III Framework:

The prudential returns or templates currently utilized by the Banking Board for compiling and analyzing financial and statistical data furnished by the banks has been in place since 1980s. So much have changed since then. As such, the Banking Board initiated a dialogue with the IMF through PFTAC to assist with the review of the current prudential regulations, standards, returns or templates. The objective is to bring these important supervisory aspects and mechanisms to-date consistent with acceptable global prudential practices. The Republic of Palau and Marshall Islands have already incorporated some of the Basel III standards into their prudential regulations. Uniformity between the three countries in this respect will yield benefits which will have positive effects on the regulated bank, i.e. a standardized electronic prudential return.

In August 2023, IMF fielded a Mission to work with the Board, during which the existing prudential regulations, returns or templates reviewed and recommendations made to strengthen the prudential regulations to be consistent with Basel III standards, meaning to capture or extract additional financial and statistical data for strengthening the regulation, supervision and risk management of banks. Four out of element Prudential Standards required under Basel III were introduced, being (1) Governance and Risk Management, (2) Capital Adequacy, (3) Credit Risk Management, and (4) Liquidity Risk Management. These draft prudential standards along with the respective returns, impact templates are currently being studied. IMF will field additional Missions focusing on trainings and workshops on each standard. Once staff is familiar with the standards, meetings with the banks will take place for another round of review prior to the formal issuance and implementation of each Regulation or Standard and accompanying Return or Template.

Crypto, Digital Currencies and Virtual Assets:

The legal tender in the FSM is the US Currency. However, crypto, digital currencies and virtual assets have been accepted in mostly developed economies as substitutes or alternative payments for goods and services between and among natural and legal persons. Staff participated in meetings sponsored by international organizations, such as IMF, World Bank and other Central Bank Authorities. Advocates for these alternative forms of payments have expressed interests to penetrate FSM markets; however, the legal tender in the FSM is USD. At the present time, these alternate forms of payments are decentralized and not backed-up by any State, thus are not regulated. These forms of payments are proven to be more convenience with less fees; however, the risks are high and protecting public interest is equally important, i.e. safety, confidentiality, stability, among others. Given the unknowns and high risks involved, the Board believes FSM is not ready to entertain digital currencies and virtual assets. 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.

The Legal tender in the FSM is the US Currency.

Mutual Cooperation's:

The Board has established mutual cooperation arrangements with recognized bank prudential regulatory and supervisory authorities in the region, US and with other international authorities. The objective is to enhance capacity building, mutual cooperation, and sharing of information. FDIC Examiner School did not avail slots to staff of the Banking Board in 2023 due to limited space. However, FDIC was contacted to provide training information for 2024. The Banking Commissioner, Banking Examination and Banking Financial Analyst had been accepted to FDIC School. The Banking Commissioner was accepted to a course that covers all five segments or areas, 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.

In 2023, staff were able to enroll in some virtual courses. Few of the related banking supervision trainings for staff were held in person and paid for by the sponsors, such as IMF.

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

On-Site Examination and Off-Site Monitoring:

FDIC Financial and Soundness Examination Team conducted examination on the domestic bank. Commissioner and staff took part in the examination which helped capacity building. For Consumer Compliance Examination by FDIC, it takes place every five years, and next Consumer Examination is slated for 2025. The last Consumer Examination on the domestic bank resulted in a rating score of #2. #1 being the best rating. The Commissioner and staff take parts in these examinations.

Off-site monitoring, review and evaluation routinely conducted as a core daily responsibility before the Board in order to assess operations, management, soundness and safety. IMF through PFTAC fielded a Mission to the FSM to introduce Basel III Risk Framework with draft regulations and prudential returns. There are eleven Basel III standards; however, four standards were introduced.

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) to assist with two areas not completed by another TA fielded prior to COVID-19. 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 remaining two phases of the TA not completed were: (1) drafting of amendment bill and regulations with emphasis on Basel III standards (including updating and incorporating Basel III standards, regulations and templates in the risk-based supervision framework for the Board, and (2) the implementation.

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 in compliance with the revised/new FSI data templates. FSI data, if accurately reported and properly compiled, is imperative for gauging the health and soundness of individual and consolidated financial institutions, thus the overall financial system of a 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. Staff participated in one of the FSI trainings in Singapore. More FSI trainings are expected in 2024, among other relevant and key training needs that are critical and essential to the regulatory/supervision of bank.

The FSI TA recommended improvement in the CALL Report template to strengthen reporting and collection of key data to allow thorough assessment on safety, soundness and stability. The CALL Report TA commenced in 2023 as part of the overall Risk Based Framework.

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 possible membership in the APG. APG provides TAs, trainings, and sensitive information to its members. It also undertakes compliance assessments.

Banking Permit/License Applications:

There was a query about obtaining a license to engage in banking business; however, due to his failure to file the standard application, his request was denied.

IMF Article IV Mission:

Every year the IMF Article IV Mission would meet with the Board to discuss overall performance of the banking system. IMF Article IV Mission again provided recommendation for FSM Development Bank to come under banking supervision.

Annual AFSPC Meeting:

The 2023 annual meeting of the Association of Financial Supervisors of Pacific Island Countries (AFSPC) was hosted by the Banking Commission of the Republic of the Marshall Islands. AFSPC decided that FSM will host the 2024 Annual Meeting. 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, for fifteen years. Both parties to the Compact agreed for the Second Compact for duration of twenty years, which came to expiration in September 2023. Again, both parties agreed to the third Compact. Similar to the Compact I and II, Compact III includes FDIC Insurance Coverage for Bank of FSM under Article XI, which subjects the Bank to compliance with 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 2023; 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 adopted the Banking Act and signed into law by the President as Public Law 1-94 codified under Title 29 of FSMC, as amended.

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 also to the macroprudential policy activities for achieving the desired financial stability outcomes. In a nutshell, the overarching goal is to minimizes probability of failure of banks 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 2023 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 2023 remains at 130. The system realizes a net income (after tax) of $16.089M compared to $7.506M in 2022.

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.

No staff turnover in 2023.

Operational Budget the Board is funded annually through appropriation by the FSM Congress. All fees paid by the banks are deposited in the General Fund. 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 2023, Congress appropriated $205,417 to cover personnel, travel, contractual services, consumable, and fixed assets. Board's internal reconciliation records show an unexpended amount of about $17, 939.84 at year-end. There were domestic (State visits) and international travels, both by Board members and staff. The Board was provided funding for the Examiner's CPA preparation course and materials under Contractual Service. **Annex II** is attached to provide additional information, including the amount for each budget 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 2023 by the Board. However, the Commissioner and Bank Examiner participated with an on-site examination by FDIC Examination Team, 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 and submission to IMF for FSI reporting purposes. FSM Banking Board serves as the focal point for FSI.

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 most critical issue in 2023 was the expiration of Article XI of the Compact of Free Association, particularly the FDIC depositor insurance coverage and other related services and technical assistance. While these benefits might not be easily quantified in monetary terms, they were indeed critical to preserving public confidence in the banking system, the safety, soundness and stability, capacity building, among others.

Staff capacity was also another challenge, especially in view of the new standards, measures and technological advances in the global financial system. As mentioned above, the existing prudential standards and reporting requirements have been in place since 1980s. Many supervisory authorities around the world are starting to adopt and implement Basel III standards and reporting formats. While the Board received a technical assistance Mission from IMF, the duration of the Mission was limited to one week, thus insufficient for a complete and thorough knowledge and skill transfer.

There are other financial entities, such as, credit unions, money transmitters, third party ATMs and perhaps the FSM Development Bank currently not under regulatory and supervisory purview. While these entities are not known for accepting "public deposits", they engage in financial transactions with the public, and public interests deserve safeguarding and protection.

FINANCIAL CONDITION & PERFORMANCE OF THE COMMERCIAL BANKING SYSTEM

The FSM banking system remained strong and stable in 2023 despite the banking turmoil that occurred in early 2023 in the US causing uncertainty and the increased focus on safety and soundness for banks internationally. The health of the commercial banks licensed and operating within the FSM, while remaining crucial to the growth and development of the nation, also primarily relies upon the economic stability of the government sector which is the dominant component of the FMS's output (GDP).

The banks' financials continue to show improvement during the year as combined *Total Assets* increased by $2.1 million to $477.2 million. The composition of total resources of the banking system for the quarter ended December 31, 2023 is broken down as follow:

		US $ In Thousands	Percentage
Liquid Assets (Cash & Due from Abroad)	$	381,592.00	80%
Loan Portfolio	$	84,015.00	18%
Bank Premises and Other Assets	$	11,559.00	2%
	$	**477,166.00**	**100%**

Total Liquid Assets stood at $381.6 million and comprised 80% of the system's total assets, an increase over the year by $2.4 million from $374.5 million in December 2022. Liquid Assets consist of *Cash* and *Foreign Assets/Due from Banks & Others Abroad*. As of the quarter ended December 31, 2023, *Cash* was at $7.0 million while *Due from Abroad* was at $374.5 million.

Total Loans slightly declined over the year by $1.6 million (-1.8%) to $84.0 million. Commercial lending decreased over the year by $1.4 million (-2.9%) to $49.5 million. Consumer lending also decreased over the year by $133 thousand (-0.4%) to $36.0 million. The loan portfolio comprised 18.0% of the system's total assets, with commercial loans composing 57.2% of the lending portfolio while consumer lending constitutes 42.8%.

On the liabilities & capital side, **Total Deposits** decreased over the year by $11.5 million (-2.6%) to $424.4 million. Total deposits comprised 88.95% of the system's total liabilities and equity. The system's deposit base structure was significantly dominated by Savings deposit facilities at $239.7 million (50.2%), followed by Demand Deposits at $168.3 million (35.3%), Time Certificates of Deposits (TCDs) at $15.7 million (3.3%), with the remaining $689 thousand (0.1%) for other deposit facilities.

Total Loan to Deposit ratio for the system stood at 19.79%. The ratio slightly increased compared to 19.63% in the same period of 2022.

Operating Highlights:

- **Total interest income** at year end 2023 was reported at $24.0 million, an increase from $13.4 million in the previous year. The **net interest margin** (net interest income/average earning assets) increased by 212 basis points over the year to 5.03%. The bank reported **prevailing interest rates** on consumer and commercial loans at 14.33% and 4.75%

respectively. The **average yield on loans plus invested funds** increased from 3.04% at end-December 2022 to 5.22% at end-December 2023.

- **Total Income** was recorded at $26.3 million, an increase compared to $15.9 million in the previous year. **Total Year-to-Date Expenses** (excluding taxes of $221 thousand) were at $16.1 million. The banks ended 2023 with $16.3 million in **Net Operating Income**. The Return on Average Assets (ROAA), net income as a percentage of average assets, improved from 1.59% at end-December 2022 to 3.34% at end-December 2023.

- 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, 2023 showed an improvement over the year as it decreased from 43.3% in 2022 to 32.8% in the current year.

- Reported **asset quality** showed slight deterioration during the year as **criticized loans as a percentage of total loans** slightly increased from 7.20% at year-end 2022 to 7.57% at year-end 2023. Although **overdue loans as a percentage of total loans** slightly increased from 1.88% in 2022 to 2.55% in 2023, it remained moderately low. **Non-accrual loans as a percentage of total loans** also slightly increased from 0.48% in 2022 to 1.57% in 2023. Total **Loan loss reserve** of the banks stood at $2.4 million as at December 31, 2023, a decrease from $3.5 million in the prior year. The consolidated reserve amount the banks are required to maintain at year end 2023 was $290 thousand. The amount of loan loss reserve kept by the bank at the end of the year was about 9 times greater than their required reserve amount. The banks reported a year-to-date charge-off of about $1.8 million, an increase compared to $1.2 million in the previous year. Total year-to-date recoveries as at end-December 2023 was $424 thousand, compared to $441 thousand in the prior year. Total year-to-date provisions for loan losses were $911 thousand at end-December 2023 and $910 thousand in the previous year.

- The banks held **total capital and reserves** at $39.651 million as of December 31, 2023, an increase by $11.071 million from $28.580 million in the same period of 2022.

The banking system's overall performance was assessed as satisfactory as of December 31, 2023, based on the banks' satisfactory levels of capital, earnings, liquidity and strong asset quality indicators as of December 31, 2023.

Capital Adequacy Indicators

❖ **The banks remain well-capitalized.** Total capital and reserves for the system stood at $39.651 million as of December 31, 2023.

❖ 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, 2023, 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 currently 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 2023 Audited Financial Statements, the bank's aggregate statutory capital exceeded the FDIC's well capitalized standards.

Asset Quality Indicators

- Asset quality remains satisfactory. Total assets increased over the year by $2.1 million (0.4%) and the asset base remains high and strong. The increase in total assets over the year was a result of the aggregate $2.4 million increase in Liquid Assets during the year.

- <u>Foreign Assets/Due from Banks & Others Abroad comprise 78.5% of the system's Total Assets.</u> Of the $374.5 million in Liquid Assets invested abroad, $323.5 million are deposited in demand/overnight and time savings with U.S. FDIC insured banks, $43.5 million are invested in U.S. Government securities (solely available for sale and guaranteed by the U.S. Government) and $7.5 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 2023 was 4.29%, a significant improvement from 1.63% in 2022.

- **The quality of the system's loan portfolio is satisfactory.** The ratio of Non-Performing Loans to Total Loans stood at 1.57%, an increase from 0.48% a year ago. Outstanding Non-Performing Loans increased by 2.19%, or $908 thousand to $1.3 million as at year-end 2023. Gross Loans decreased over the year by $1.6 million (-1.8%); commercial loans decreased over the year by $1.4 million (-2.9%) and consumer loans decreased by $133 thousand (-0.4%).

- **Loan Loss Reserves is sufficient**. The current level of loss allowance as of December 31, 2023, is about over nine 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, 2023, the level of loss allowance stood at $2.4 million, well above Banking Board's minimum and recommended level. The banks had reported a year-to-date charge-off of $1.8 million against recoveries of $424 thousand.

- Criticized Loans consist of Special Mention, Substandard, Doubtful and Loss Loans. Loans that fall in these categories are those that either exhibit some weaknesses that jeopardize full repayment of the loans if not promptly corrected, collection or liquidation of the debt in full is highly questionable, or loans become uncollectible or of insufficient current value to warrant being maintained as bankable assets. Special Mention loans slightly decreased from $4.94 million in 2022 to $4.90 million in 2023. Substandard loans increased from $1.21 million in the prior year to $1.44 million; Doubtful loans decreased over the year from $180 thousand to $12 thousand; and Loss loans decreased from $12 thousand to nil at year end 2023. 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 Indicators

- ❖ **Earnings performance for the banks is satisfactory.** The banks' income performance has substantially improved as their aggregated net income has increased to $16.1 million at year end December 2023.

- ❖ The Banks managed to end year 2023 with $16.3 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.
- ❖ The system generated Net Income of $16.1 million for the period ended December 31, 2023, up from $7.5 million at year-end 2022. Total Interest Income has increased by $10.5 million to $24.0 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 $26.3 million, an increase from $15.9 million at year-end 2022. Total interest income improved over the year as yield on invested funds improved from 1.63% in 2022 to 4.29% in 2023.

- ❖ Total Year-To-Date Expenses (excluding taxes of $221 thousand) was about $10.0 million, a drop by $2.0 million from $8.0 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 3.34%, from 1.59% a year ago. The increase is mainly due to the improvements in average yield on invested funds abroad.

FSM Banking System

Consolidated Income and Expense Statement (5 Years)

(inU.S.'000s)	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23
Interest Income	13,451	9,956	8,520	13,444	23,985
Interest Expense	592	296	119	314	663
NETINTERESTINCOME	**12,859**	**9,660**	**8,401**	**13,130**	**23,322**
Provisions For Bad Loans Expense	**542**	**998**	**330**	**910**	**911**
NON-INTERESTINCOME	**1,991**	**1,690**	**1,801**	**2,419**	**2,301**
NON-INTERESTEXPENSE	**6,677**	**6,307**	**6,312**	**6,736**	**8,402**
Net Operating Income	7,631	4,045	3,560	7,903	16,310
Less: Taxes	295	239	291	397	221
Net Income	**7,336**	**3,806**	**3,269**	**7,506**	**16,089**

Liquidity Indicators

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

- Total Liquid Assets stood at $381.6 million and made up 89.90% of Total Deposits as of December 31, 2023. The ratio increased from 86.98% in 2022. This means that for every dollar in deposit liabilities, the banking system maintained about 90 cents in liquid assets.
- Even though local liquid assets (i.e., cash balances) aggregated for both banks cover just 1.85% 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 $11.5 million (-2.6%) to $424.4 million.

- The ratio of Total Loans to Total Deposits slightly increased from 19.63% in 2022 to 19.79% in 2023, commensurate with the reported decrease in loans over the year while deposits also 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 excess deposits continue to be taken in by banks while loans remain stagnant. 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 2023, there were 28,291 deposit accounts at the commercial banks; of which 2,642 belong to Small Medium Enterprise (SME) accounts and 25,145 belong to household sector accounts. The total number of deposit accounts decreased when compared to 29,755 at year end 2022. The decrease was due to both decreases in household accounts by 1,303 and SMEs by 33. Outstanding deposits at year end 2023 were $424.4 million; of which $148.4 million are in SME accounts and $95.6 million are in household accounts. Deposit amounts decreased compared to $435.9 million in 2022. Both banks showed decreases in both the number of accounts and the outstanding deposit amounts during the year.

❖ The number of loan accounts at year end 2023 was 7,877; of which 107 belong to SMEs and 6,835 belong to household. Number of loans increased from 7,608 in 2022. Outstanding loans stood at $84.0 million; of which $18.4 million are issued to SMEs and $29.2 million to households. During the year, the total balance in loans decreased by $1.6 million from $85.6 million in 2022.

Key Performance Indicators

KEY RATIOS (%)	December 31, 2022	December 31, 2023
Balance Sheet Ratios:		
Liquid Assets % of Deposits	86.98%	89.90%
Total Loans % of Total Deposits	19.63%	19.79%
Consumer Loans % of Total Loans	42.21%	42.84%
Commercial Loans % of Total Loans	57.79%	57.16%
Invested Funds % of Total Deposits	85.18%	88.24%
Invested Funds % of Total Assets	78.15%	78.49%
Liquid Assets % of Total Assets	79.80%	79.97%
Asset Quality Ratios:		
Overdue Loans as % of Total Loans	1.88%	2.55%
Criticized Loans as % of Total Loans	7.20%	7.57%
Non-Accrual Loans as % of Total Loans	0.48%	1.57%
Loss Reserves as % of Total Loans	4.10%	2.91%
Provisions as % of Total Loans	1.06%	1.08%
Classified as % of Total Loans	7.20%	7.57%
Classified Consumer % of Total Consumer	2.36%	2.70%
Classified Commercial % of Total Commercial	10.74%	11.21%
Interest Measures:		
Average Yield on Loans	9.24%	9.40%
Average Yield on Invested Funds	1.63%	4.29%

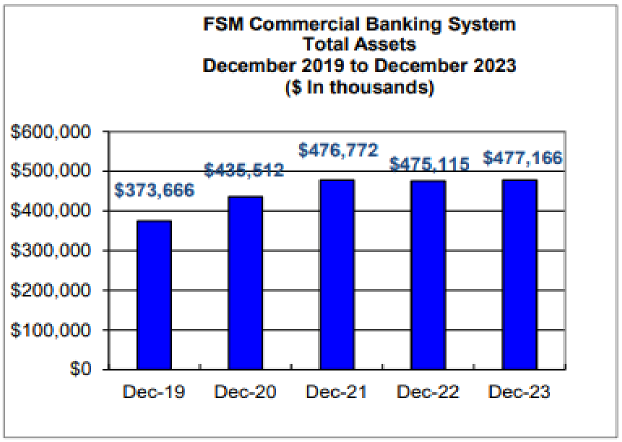
Average Cost of Deposits	0.07%	0.15%
Interest Spread (Yield -Cost)	2.97%	5.07%
Net Income to Average Assets (ROAA)	1.59%	3.34%
Net Int Inc to Avg Earning Assets (NIM)	2.91%	5.03%

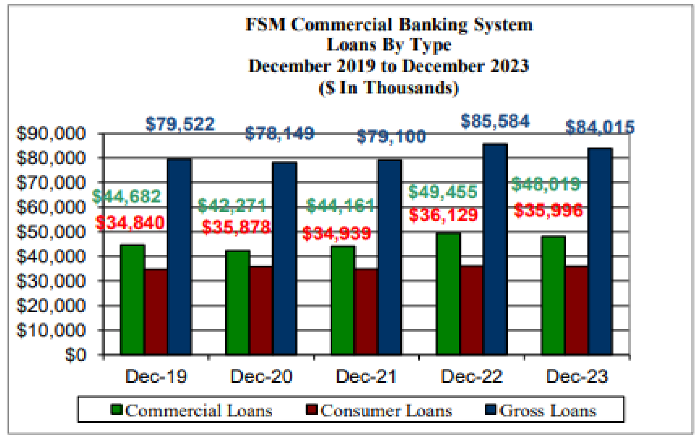
FINANCIAL SOUNDNESS INDICATORS

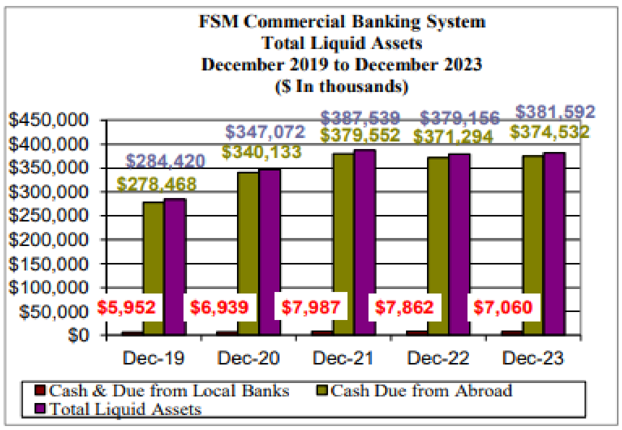
Financial Soundness Indicators (Core)	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23
Capital-based					
Regulatory capital to risk-weighted assets	35.24	37.57	37.24	38.48	38.95
Regulatory Tier 1 capital to risk-weighted assets	35.24	37.57	37.24	38.48	38.95
Non-performing loans net of provisions to capital	1.93	1.05	2.90	3.72	4.25
Asset Quality					
Non-performing loans to total gross loans	1.25	0.60	1.28	1.39	1.73
Sectoral distribution of loans to total loans:					
Residents	65.86	65.32	68.16	63.79	64.49
Interbank loans	-	-	-		
Other financial corporations	-	-	-		
Non-financial corporations	59.51	59.24	62.88	56.66	60.86
Other domestic sectors	6.34	6.07	5.28	7.13	3.63
Non-residents	34.14	34.68	31.84	36.21	35.51
Earnings and Profitability					
Return on assets	1.98	0.91	0.70	1.65	3.37
Return on equity	26.23	13.29	11.71	29.53	46.94
Interest margin to gross loans	86.59	85.12	82.35	84.45	91.02
Noninterest expense to gross income	46.95	57.68	64.72	44.65	33.65
Liquidity					
Liquid assets to total assets	62.24	58.53	67.35	60.39	58.53

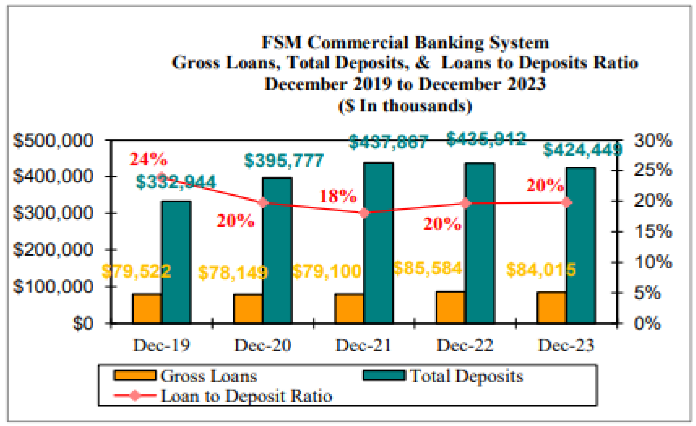
Financial Soundness Indicators (Encouraged)	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23
Capital to assets	6.11	5.59	5.34	5.55	5.81
Customer deposits to total (non-interbank) loans	418.68	506.44	553.56	493.73	505.21
Personnel expenses to non-interest expenses	45.88	51.80	50.16	48.69	45.17
Foreign -currency-denominated loans to total loans	0.16	0.13	0.12	0.12	0.14

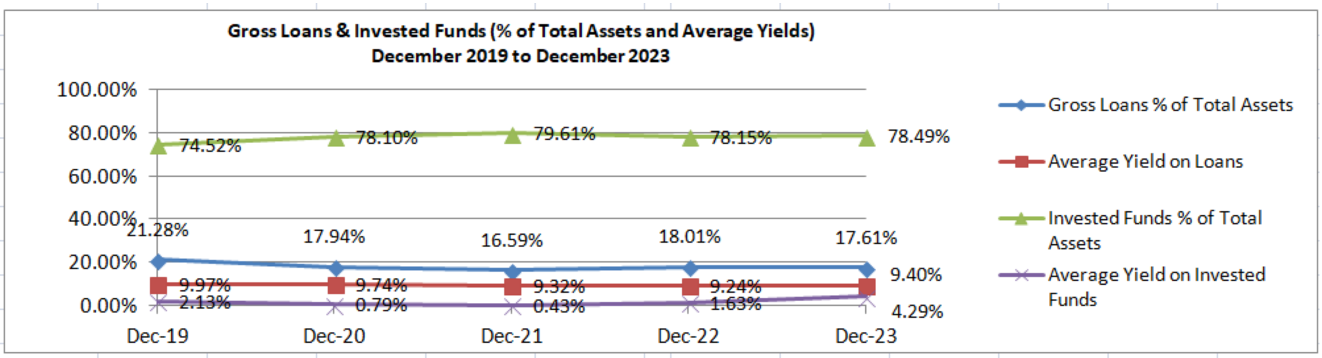
4th Quarter 2023 FSM Commercial Banking System Graphic Reports

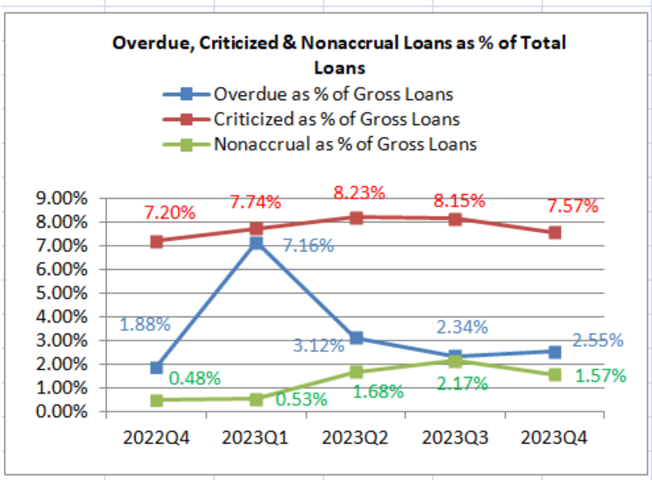


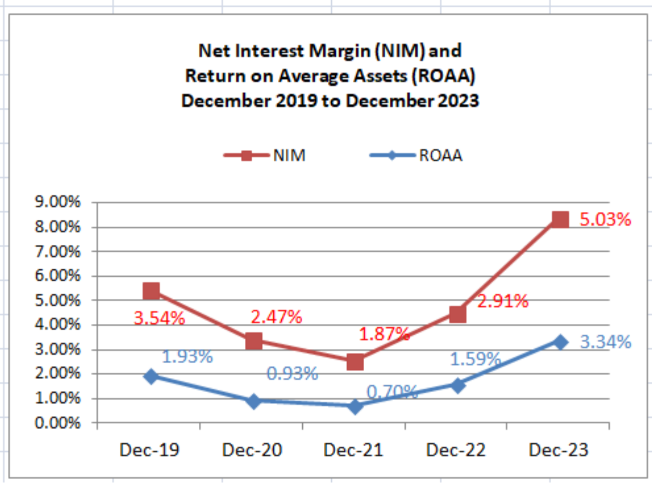




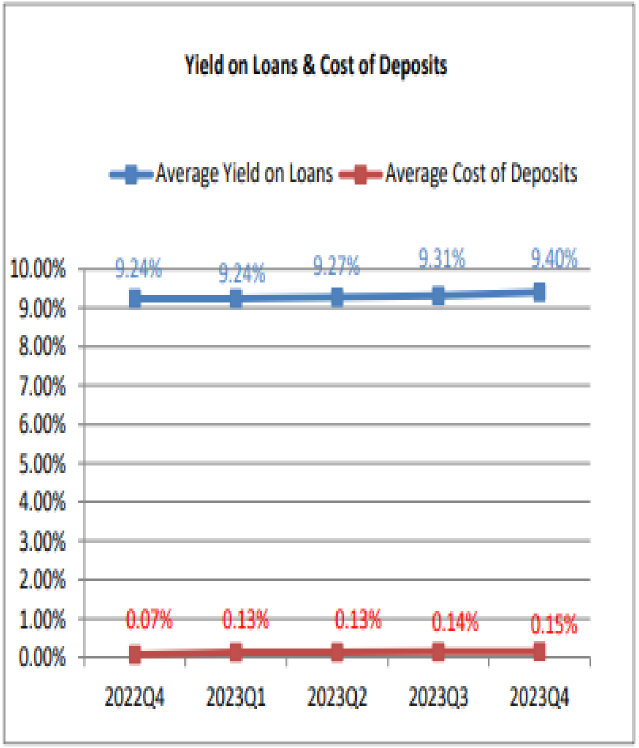


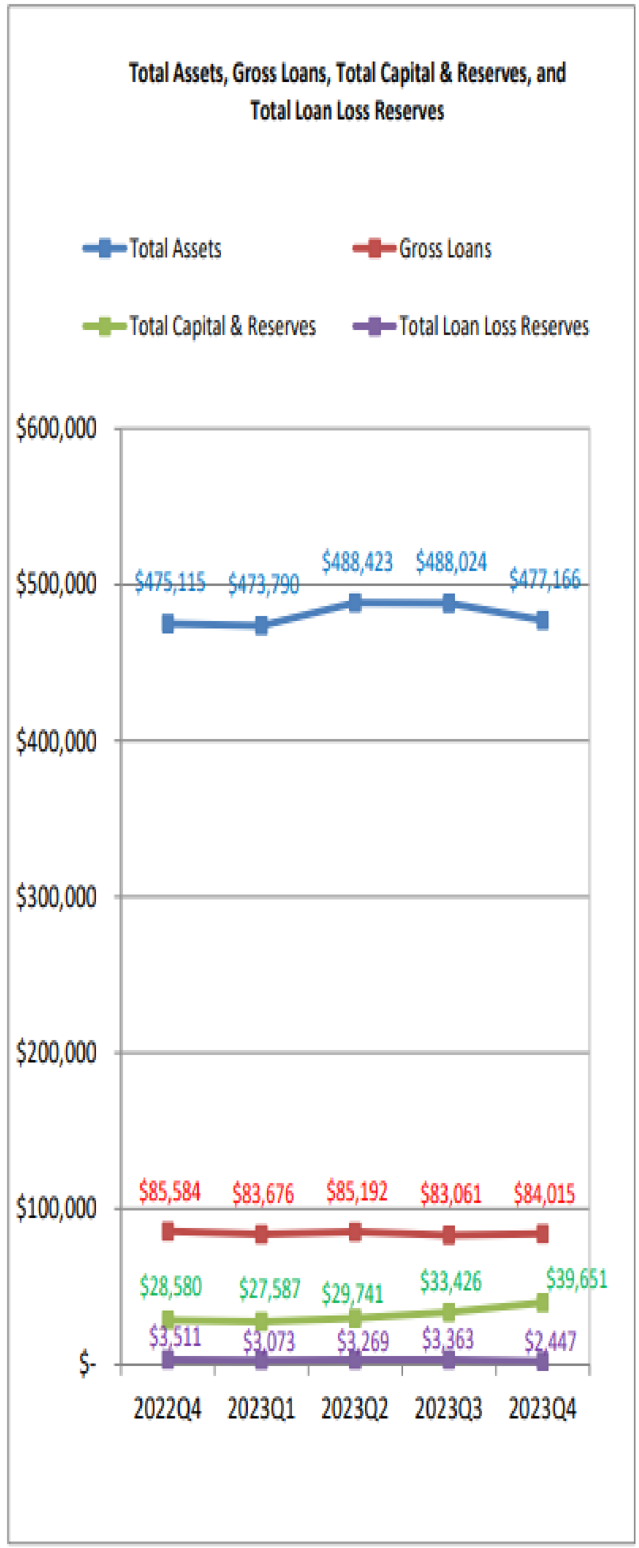


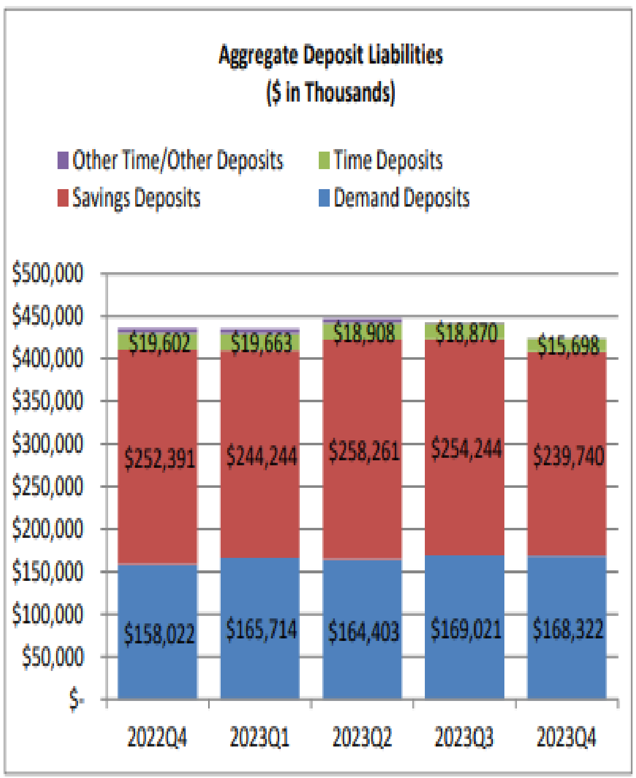




4th Quarter 2023 FSM Commercial Banking System Graphic Reports

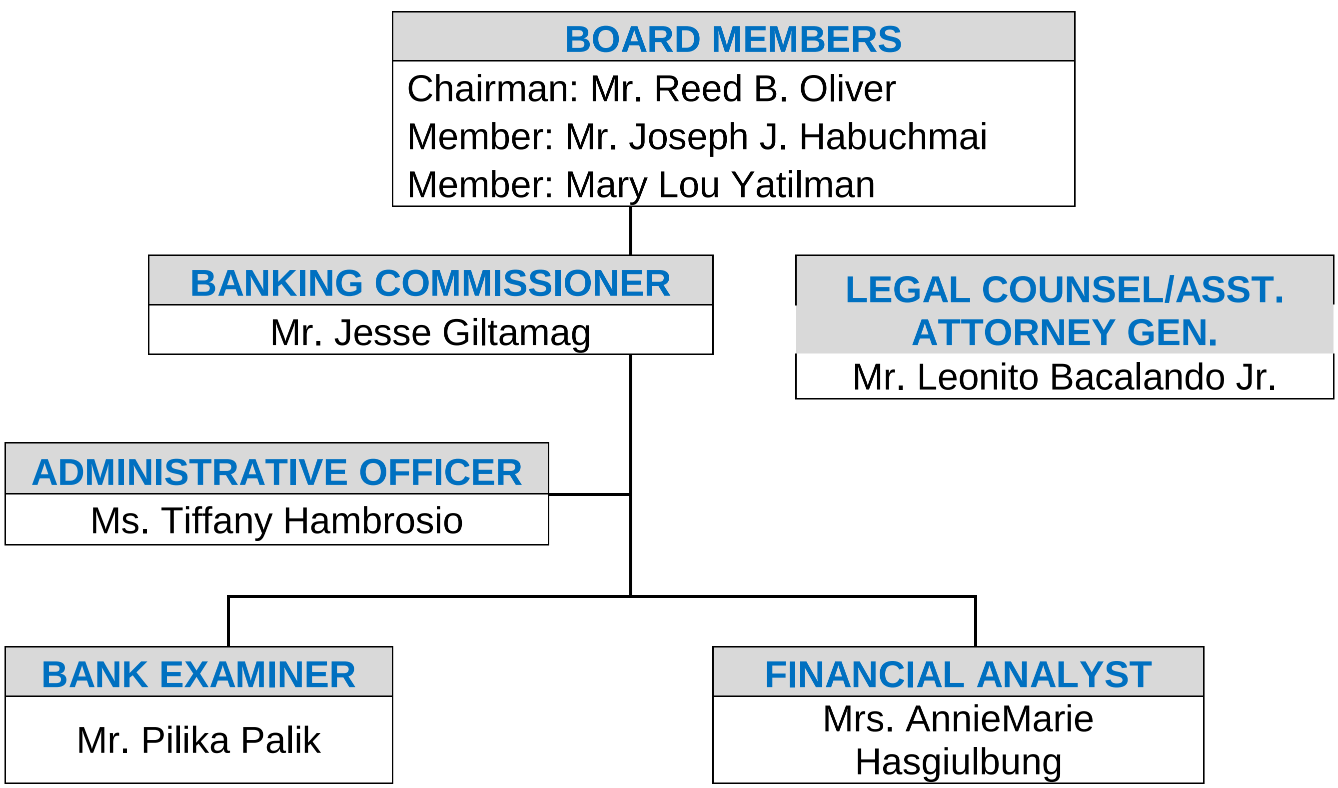






Annex I: Organization Chart

ORGANIZATION OF FSM BANKING BOARD



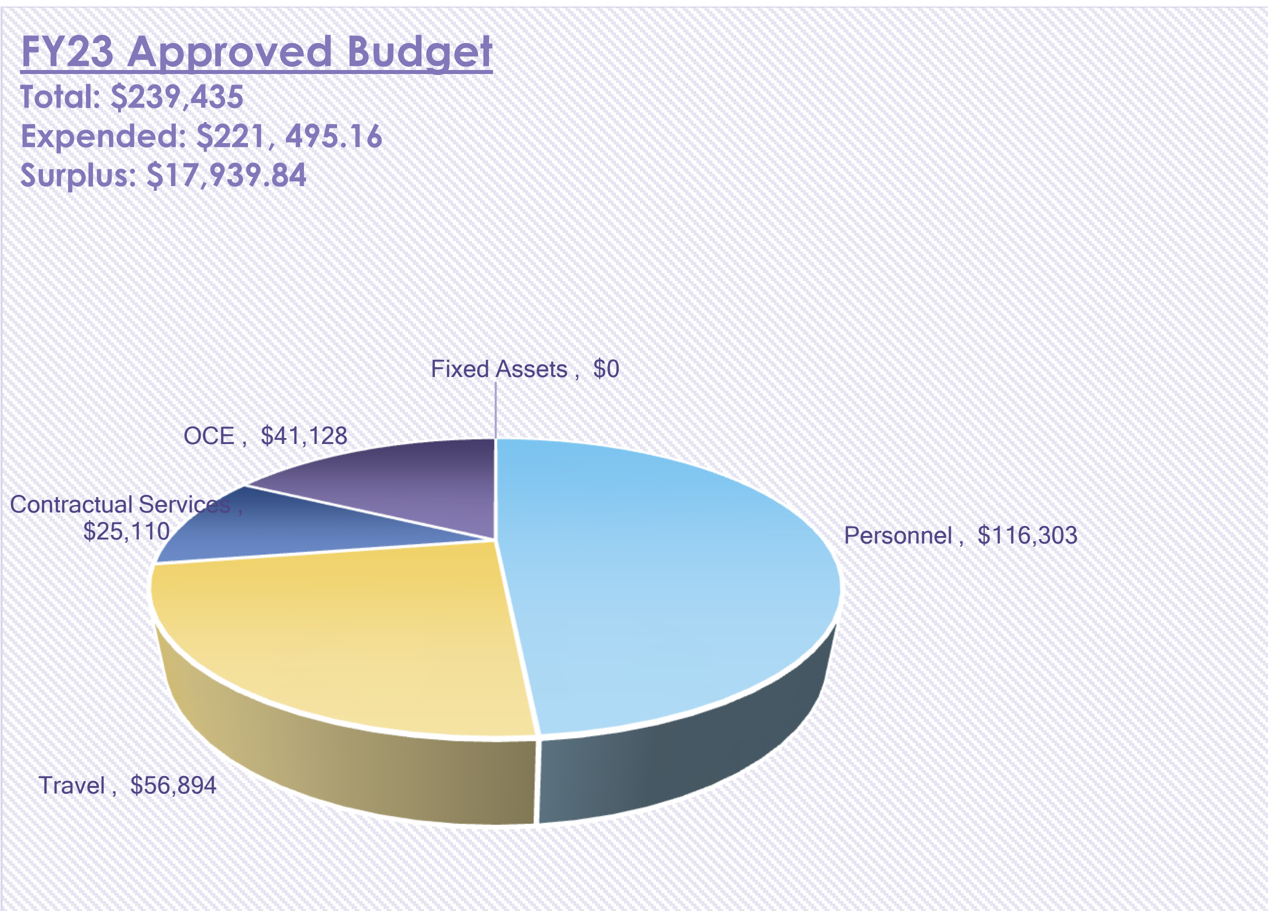
Annex II: Fiscal Year 2023 Budget

The total appropriation for Fiscal Year 2023 for the FSM Banking Board was **$239,435,** the breakdowns on which below:

- **Personnel:** $116,303 was allocated for Personnel and was exhausted out.
- **Travel:** $56,894 was allocated for travel; Domestic travel to all the States with Board members to brief the leadership and general public on the status of the banking system, especially post COVID-19 pandemic. Left with a surplus of $9,694.92.
- **Contractual Services:** $41,128 was allocated for contractual services of which $39,092.73 was expended.
- **Consumables:** $25,110 was allocated to consumables. $6,209.65 was realized as unexpended.
- **Fixed Assets:** $0

From the total appropriation of **$239,435**, about $17,939.84 shown as unspent amount per internal records.

Chart 1: Approved amount for each Budget Category



Annex III: Balance Sheet: December 31, 2023

FSM COMMERCIAL BANKING SYSTEM
BALANCE SHEET
December 31, 2023

(US$ In Thousands)	31-Dec-23	%	31-Dec-22	%	Yearly Variance	% Change	30-Sep-23	%	Quarterly Variance	% Change
ASSETS										
Cash & Due from Local Banks	7,060	1%	7,862	2%	(802)	-10.2%	9,456	2%	(2,396)	-25.3%
Foreign Assets/Due from Banks & Others Abroad	374,532	78%	371,294	78%	3,238	0.9%	384,931	79%	(10,399)	-2.7%
Total Liquid Assets	**381,592**	80%	**379,156**	80%	2,436	0.6%	**394,387**	81%	(12,795)	-3.2%
Loans					-				-	
Commercial	48,019	10%	49,455	10%	(1,436)	-2.9%	47,877	10%	142	0.3%
Consumer	35,996	8%	36,129	8%	(133)	-0.4%	35,184	7%	812	2.3%
Total Loans	**84,015**	18%	**85,584**	18%	(1,569)	-1.8%	**83,061**	17%	954	1.1%
Other Assets	11,559	2%	10,375	2%	1,184	11.4%	10,576	2%	983	9.3%
Total Assets	**477,166**	100%	**475,115**	100%	2,051	0.4%	**488,024**	100%	(10,858)	-2.2%
LIABILITIES & CAPITAL										
Deposits										
Demand	168,322	35%	158,022	33%	10,300	6.5%	169,021	35%	(699)	-0.4%
Savings	239,740	50%	252,391	53%	(12,651)	-5.0%	254,244	52%	(14,504)	-5.7%
Time	15,698	3%	19,602	4%	(3,904)	-19.9%	18,870	4%	(3,172)	-16.8%
Other Time/Other Deposits	689	0%	5,897	1%	(5,208)	-88.3%	789	0%	(100)	-12.7%
Total Deposits	**424,449**	**89%**	**435,912**	92%	(11,463)	-2.6%	**442,924**	91%	(18,475)	-4.2%
Other Liabilities & Capital 1/	52,717	11%	39,203	8%	13,514	34.5%	45,100	9%	7,617	16.9%
Total Liabilities & Capital	**477,166**	100%	**475,115**	100%	2,051	0.4%	**488,024**	100%	(10,858)	-2.2%
Memorandum Items:										
Loan/Deposit Ratio (%)	20%		20%				19%			
Consumer Loans (% of total loans)	43%		42%				42%			
Commercial Loans (% of total loans)	57%		58%				58%			

Footnote:

1/ Includes loan loss reserves

Source: FSM Banking Board