

**FOR
INFORMATION**

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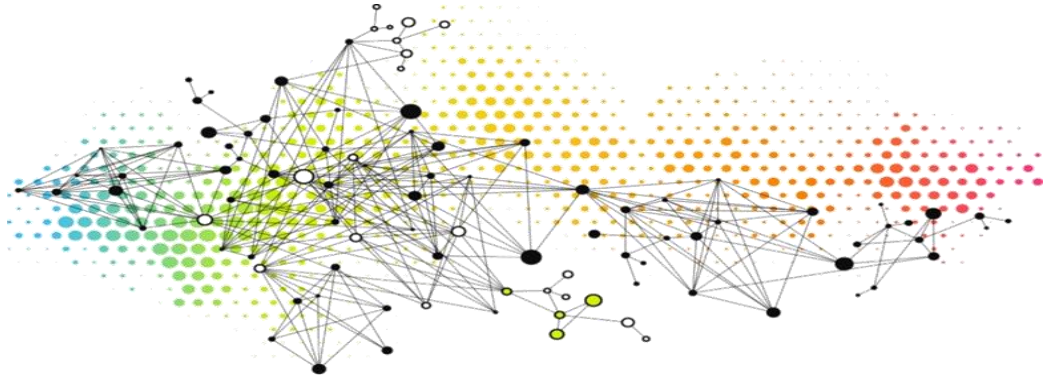
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FEDERATED STATES OF MICRONESIA

MAY 2021

TECHNICAL ASSISTANCE REPORT ON THE FINANCIAL SOUNDNESS INDICATORS MISSION (NOVEMBER 2–13, 2020)

Prepared by Mahmut Kutlukaya

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Glossary

| | |
|------------------|---|
| APD | IMF's Asia & Pacific Department |
| CBCSDI | Cross-border, Cross-sector, Domestically Incorporated consolidation basis |
| CFA | Compact of Free Association |
| DL | Domestic location basis |
| DT | Deposit taker |
| FAS | Financial Access Survey |
| FDIC | Federal Deposit Insurance Corporation |
| FFIEC | Federal Financial Institutions Examination Council |
| FS2 | Sectoral financial statements and memorandum series template |
| FSD | Sectoral financial soundness indicators template |
| FSI | Financial soundness indicator |
| <i>FSI Guide</i> | <i>Financial Soundness Indicators Compilation Guide 2019</i> |
| FSM | Federated States of Micronesia |
| FSMBB | Federated States of Micronesia Banking Board |
| FSMDB | Federated States of Micronesia Development Bank |
| FSMIB | Federated States of Micronesia Insurance Board |
| FX | Foreign exchange |
| IAS | International Accounting Standards |
| ICS | Integrated Collection System |
| IMF | International Monetary Fund |
| MFS | Monetary and Financial Statistics |
| NPL | Nonperforming loans |
| NSDP | National Summary Data Page |
| OCI | Other comprehensive income |
| PFTAC | Pacific Financial Technical Assistance Centre |
| ROA | Return on assets |
| ROE | Return on equity |
| RWA | Risk-weighted asset |
| SNA | System of National Accounts |
| SRF | Standardized report forms |
| STA | IMF's Statistics Department |
| TA | Technical assistance |
| US GAAP | United States Generally Accepted Accounting Principles |

SUMMARY OF MISSION OUTCOMES AND PRIORITY RECOMMENDATIONS

1. The International Monetary Fund's (IMF's) Statistics Department (STA) provided technical assistance (TA) on financial soundness indicators (FSI) to the Federated States of Micronesia Banking Board (FSMBB) during November 2-13, 2020. The TA mission took place in response to a request from the authorities, with the support of the IMF's Asia & Pacific Department (APD). The mission was conducted remotely via video conferences due to the COVID-19 pandemic and travel restrictions. The mission worked with the staff of the FSMBB on the development of FSIs that are in line with the IMF's 2019 *FSI Guide*.¹ The main objectives of the mission were to: (i) review the source data, institutional coverage and accounting and regulatory frameworks supporting the compilation of FSIs; (ii) provide guidance for mapping source data for the banking sector to the FSI reporting templates FS2 and FSD as well as areas for improvement in the metadata; (iii) agree with the FSMBB the timeline to begin regular reporting of the FSIs for deposit-takers to STA, conditional on the availability and completeness of the source data; and (iv) agree on the timeliness of data reporting.

2. The Federated States of Micronesia reported 11 core and 6 encouraged FSIs to STA but stopped reporting via the Integrated Collection System (ICS) in 2016Q2. The FSMBB continued reporting via the National Summary Data Page (NSDP) with a twenty-month lag. However, these FSIs were not always consistent with the FSI Guide methodology and have not been disseminated by STA in the FSIs database.

3. As a result of the mission, the FSMBB is now in a position to report quarterly FSIs to STA in line with the 2019 FSI Guide. The mission compiled, together with staff of the FSMBB, 18 FSIs for deposit takers (DTs), and two FSIs on the size of OFC's sector from the available source data. The coverage of DTs for the compilation of FSIs includes 2 commercial banks which cover the entire DTs sector other than credit unions. The FSIs for DTs cover key aspects of capital adequacy, asset quality, earnings and profitability, and liquidity, providing a useful input for financial stability analysis.

4. The mission reviewed the FSIs currently compiled by the FSMBB to assess consistency with the 2019 FSI Guide. Series with discrepancies identified during the mission include; sectoral distribution of loans, nonperforming loans (NPLs) net of provisions to capital, capital to risk weighted assets ratios, return on equity and liquid assets (Appendix III). The mission made recommendations to the FSMBB to compile their FSIs in line with the *2019 FSI Guide*.

5. The FSMBB's legal and reporting framework for banking supervision provides the basis for source data needed for FSI compilation. The mission had access to aggregate data

¹ The work of the mission was facilitated by the excellent cooperation provided by officials of the FSMBB.

for the deposit takers for the period March 2006 to June 2020 and to bank-by-bank data for June 2020. The mission was able to assist the FSMBB in their mapping to the FSI workbook and in the validation of aggregated data from bank- by- bank data for June 2020. In addition, the mission reviewed source data from the balance sheet, income statement, and supervisory data from March 2006 to June 2020 and made various recommendations to improve the collection of source data. The FSMBB staff would need to compile FSIs in line with the framework developed while addressing the data discrepancies that were observed during the mission before submission to the FSIs to STA.

6. Improvements in the source data reported to the FSMBB for FSI compilation could be strengthened, as recommended in this report. While source data reported by the banks are broadly adequate for the calculation of various FSIs indicators for deposit-takers in terms of their quality, frequency, and timeliness, some shortfalls need to be addressed, including:

i) strengthening the collection of liquid assets, customer deposits, risk weighted assets and regulatory capital series; ii) strengthening the FSMBB's validation and reconciliation of data among the different call reports to ensure that the source data reported by banks are consistent, accurate and complete; and iii) clarifying the definition of capital and reserves and specific provisions in the balance sheet.

7. A timeframe for reporting FSI data and metadata to the IMF was discussed and agreed on with FSMBB officials. FSMBB staff could compile quarterly FSIs for DTs using the workbook developed by the mission and agreed on for reporting FSI data and metadata to STA for disseminating on the IMF's FSI website. As of November 2020, 143 countries' FSI data are disseminated on the FSI website, allowing for cross-country comparisons and analyses that are useful to policy makers and analysts.

8. To support progress in the above work areas, the mission recommended a detailed action plan summarized by the following priority recommendations:

Table 1. FSM: Priority Recommendations

| Target Date | Priority Recommendation | Responsible Institutions |
|---------------|---|--------------------------|
| January 2021 | <i>Implement quality control checks for data submitted by commercial banks and closely work with them to explain reporting requirements and resolve data discrepancies.</i> | FSMBB |
| February 2021 | <i>Finalize and report to STA for review the FSI sectoral financial statements (FS2 template) for DTs, including balance sheets, income statements, and memorandum series, the sectoral FSIs with underlying series (FSD template) for DTs with quarterly data beginning from 2006: Q1, the FSI institutional coverage (FS1 template)</i> | FSMBB |

| Target Date | Priority Recommendation | Responsible Institutions |
|-------------------|--|--------------------------|
| | <i>with annual data starting from 2006, and the FSI metadata (FSM template).</i> | |
| March 2021 | <i>Start regular reporting to STA, for disseminating on the IMF's FSI website, of the FSD and FS2 templates with quarterly data starting from 2006: Q1, and the FS1 template with annual data starting from 2006. Also report the FSM template periodically.</i> | FSMBB |

DETAILED ACTION PLAN

| Priority ¹ | Action/Milestone | Target Completion Date |
|---|--|------------------------|
| 1/ Priority scale: H–High; M–Medium; L–Low. | | |
| H | <i>Implement quality control checks for data submitted by commercial banks and closely work with them to explain reporting requirements and resolve data discrepancies. Benchmark</i> | 01/31/2021 |
| H | <i>Finalize and report to STA for review the FSI sectoral financial statements (FS2 template) for DTs, including balance sheet, income statement, and memorandum series, the sectoral FSIs with underlying series (FSD template) for DTs with quarterly data beginning from 2006: Q1, the FSI institutional coverage (FS1 template) with annual data starting from 2006, and the FSI metadata (FSM template). Benchmark</i> | 02/28/2021 |
| H | <i>Start regular reporting to STA, for disseminating on the IMF's FSI website, of the FSD and FS2 templates with quarterly data starting from 2006: Q1, and the FS1 template with annual data starting from 2006. Also report the FSM template periodically. Benchmark</i> | 03/31/2021 |
| H | <i>Align the sectoral classification of deposits (SS 1B form) with the 2019 FSI Guide.</i> | 06/30/2021 |

| Priority ¹ | Action/Milestone | Target Completion Date |
|-----------------------|--|------------------------|
| H | <i>Collect the data on the amount of specific provisions set aside for nonperforming loans in the Criticized Assets Call Report (Report No. 5).</i> | 06/30/2021 |
| H | <i>Clarify the definition of capital and reserves in the balance sheet and collect additional information on the subcomponents of capital and reserves.</i> | 06/30/2021 |
| H | <i>Provide a definition of nonperforming loans in the criticized assets call report in line with the 2019 FSI Guide and eliminate partial reporting of NPLs based on collateralization (Report No. 5).</i> | 06/30/2021 |
| H | <i>Calculate the spread between the reference lending and deposit rates using the template provided once the data quality issues are resolved (Report No. 6.A).</i> | 06/30/2021 |
| H | <i>Provide clear instructions to banks to guide properly fill-in their Tier-1 capital in the call report (Report No. 3).</i> | 12/31/2021 |
| H | <i>Introduce a comprehensive definition of risk weighted assets and the necessary call report to collect additional information on capital adequacy ratios.</i> | 12/31/2021 |
| H | <i>Collect information on the maturity profile of assets and liabilities with a specific call report.</i> | 12/31/2021 |
| H | <i>Define liquid assets and collect data in line with the 2019 FSI Guide definition.</i> | 12/31/2021 |
| M | <i>Revise the balance sheet call report (Report No. 1) to incorporate financial derivatives on both the asset and liability sides.</i> | 12/31/2021 |
| M | <i>Collect memorandum items with detail of accrued interest by instrument.</i> | 12/31/2021 |
| M | <i>Collect residential real estate and commercial real estate loans data in line with the definitions provided in the 2019 FSI Guide.</i> | 12/31/2021 |
| M | <i>Collect other comprehensive income (OCI) data.</i> | 12/31/2021 |
| M | <i>Collect call reports in the electronic format.</i> | 12/31/2021 |

INTRODUCTION

A. Background

9. This was the first STA mission on FSIs specifically for the FSMBB. Previously, STA has delivered two workshops to assist the Federated States of Micronesia (FSM) and other Pacific island countries regarding FSIs. An FSI training workshop was conducted in Fiji during February 2–6, 2015, for the seven Pacific Island countries (the Republic of Fiji, FSM, Papua New Guinea, the Solomon Islands, Samoa, Tonga, and Vanuatu) and Maldives to improve participants' knowledge of the IMF-recommended methodology for compiling FSIs and to assist them in data compilation and dissemination. STA has also conducted a one-week FSI workshop in Fiji to advance the FSI work for seven Pacific Island countries during April 4–8, 2016.

10. Federated States of Micronesia reported 11 core and 6 encouraged FSIs to STA through ICS until 2016Q2. The FSMBB continued reporting via the NSDP with a twenty-month lag after 2016Q2. However, FSIs received through the NSDP were not always consistent with the FSI Guide methodology and have not been disseminated by STA in the FSIs database.

11. FSMBB regulates and supervises commercial banks in FSM. However, the Federated States of Micronesia Development Bank (FSMDB) and credit unions are not regulated or supervised by the FSMBB. A Banking Regulatory Reform project, with an objective to strengthen the banking regulation and supervision capacity, was initiated by The Federated States of Micronesia Banking Board (FSMBB) in July 2017. In this context, the Pacific Financial Technical Assistance Centre (PFTAC) and the IMF's Legal Department has been providing Technical Assistance (TA) to the FSMBB in reviewing the current FSM Bank Act. The TA covers bringing the FSMDB and credit unions under FSMBB surveillance and developing prudential regulations on regulatory capital, related party exposures, large exposures, credit classification and provisioning and corporate governance and risk management.²

12. Deposit takers in the FSM are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank of FSM (BFSM) is covered by FDIC insurance under the Compact of Free Association (CFA), whereas Bank of Guam, established in a US territory, is also FDIC insured. Deposit takers are subject to regulatory reporting to the Federal Financial Institutions Examination Council (FFIEC) as required by the FDIC. FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions in the United States by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB), and to make recommendations to promote uniformity in the supervision of financial institutions.

² IMF Country Report No. 19/288 (Article IV Report) recommended the FSMDB and credit unions to be placed under the supervision of the Banking Board in order to ensure prudent lending.

13. The CFA between the FSM and the United States, valid for a period of 20 years, was approved in December 17, 2003. While the FSMBB is optimistic about the renewal of the CFA in 2023, failure of renewal might create important strains on the FSM's banking sector.

14. The FSM economy was negatively affected by the Covid-19 outbreak. Tourism and related industries were affected the most from the travel restrictions implemented following the outbreak. However, the FSMBB officials assessed the effect of Covid-19 on the banking sector as manageable. Financial soundness indicators have not shown financial stability risks stemming from Covid-19. One commercial bank implemented a voluntary blanket moratorium of consumer loans and personal credit cards between May and July 2020.

B. FSM's Financial System

15. The FSM's financial system is comprised of two deposit takers, one development bank, 32 insurers and 5 credit unions. Banks dominate the financial system in the FSM. As of June 2020, total reported assets of the financial system (excluding insurance companies, the pension fund and credit unions) were USD 479,7 million. Assets of the commercial banks constitute around 85 percent of this total and the government owned development bank, the FSMDB, holds 15 percent share. There is no central bank in the FSM. An overview of the structure of the entire financial sector is presented in Table 2.

16. The FSM Bank Act of 1980³ sets out the functions, responsibilities, and powers of the FSMBB. The principal purposes of the Banking Board are: (i) to undertake the licensing and supervision of banks; (ii) to protect the interests of depositors; and (iii) to promote the soundness, stability, and development of the banking system of the FSM. Regulatory framework for banks is entirely defined in the FSM Bank Act and supporting prudential standards or regulations have not been issued by the FSMBB.

17. The insurance sector is regulated and supervised by the Insurance Board (FSMIB) pursuant to Title 37 of the Code of the Federated States of the Micronesia. FSMIB's principal duties are to regulate insurance sector in the FSM; to undertake the licensing and supervision of insurance sector; to protect the interests of policyholders, and to promote and develop a sound and functioning insurance system in the FSM.

³ Title 29 of the Code of the Federated States of the Micronesia.

Table 2. FSM: The Financial Sector in FSM

| Sector | Number of institutions | Total assets (In Millions USD) June 2020 | Total assets (Percent of Nominal GDP**) |
|--|------------------------|--|---|
| Central Bank | - | - | - |
| Commercial Banks | 2 | 411.4 | 102 |
| o/w domestically controlled | 1 | 196.8 | 49 |
| o/w foreign controlled | - | - | - |
| o/w branches of foreign banks | 1 | 214.6 | 53 |
| State-owned banks | - | - | - |
| Development banks | 1 | 68.3 | 17 |
| Deposit taking microfinance institutions | - | - | - |
| Non-Deposit taking microfinance institutions | - | - | - |
| Other deposit takers | 5 | 4.1* | 1 |
| Insurance | 32 | NA | - |
| o/w life and nonlife insurance | 7 | NA | - |
| o/w captive insurance | 25 | NA | - |
| Pension funds | 1 | NA | - |
| Other financial institutions | - | - | - |

Source: FSMBB.

* Data for the largest credit union based on FSMBB survey conducted in 2019.

** Nominal GDP based on end-2018.

18. The Other Depository Corporations sector comprises two deposit banks and five credit unions, with total assets of about USD 415.5 million at June 2020 (Table 2):

- **Commercial banks are licensed by the FSMBB to provide traditional banking services such as accepting deposits and extending loans.** There are currently 2 licensed deposit taking banks in FSM, of which 1 is domestically incorporated (Bank of FSM) and the other one is a branch of a foreign bank (Bank of Guam – FSM Branch).
- **The Bank of FSM (BFSM) is a private bank, in which the central government owns 24 percent share.** BFSM provides a range of banking services including; retail and

commercial loans, inward and outward wire transfers and bank guarantees. Deposits collected by the BFSM are insured by the FDIC under the CFA.

- **The Bank of Guam – FSM Branch (BoG), not a separately incorporated legal entity, is a branch of the BoG whose headquarters are located in Guam.** The BoG engages in commercial and retail banking business in FSM and as of 2020Q2 holds more than 50 percent of the total assets and total deposits in the FSM deposit taker’s sector.
- **There are currently 5 credit unions operating in the FSM.** Credit unions accept deposits only from their members and extend loans only to their members. Traditionally, the credit unions have kept these deposits predominantly at savings accounts with the commercial banks. Credit unions are excluded from Micronesia Bank Act and are not subject to any oversight by the Banking Board. They are not subject to any form of prudential supervision by their state authorities either. In certain cases, there is state level law governing the operation of credit unions; however, there is no unified or common law for credit unions. Work is ongoing on bringing the credit unions under the oversight of the FSMBB.

19. Currently there are no DTs in receivership or liquidation in FSM. The *FSI Guide* recommends including DTs in distress if they hold significant positions and to compile FSIs both including and excluding these DTs.

20. The Other Financial Corporation (OFC) sector includes development banks, insurance corporations and pension funds.

- **The FSMDB operates as a financial development institution and does not accept deposits.** FSMDB provides financing to commercial businesses mainly in the FSM. Over the years, the bank has expanded its services by creating a residential home loan program in 2008 to help locals build their homes and a consumer lending revolving fund program in 2011. Currently, FSMDB is not under the oversight of the FSMBB.
- **As of December 2019, there were six registered foreign insurers, 25 licensed captive insurance companies⁴, three licensed insurance agents⁵ and two licensed insurance brokers⁶ operating in the FSM.** Additionally, a government owned and operated health insurance provider is not under the regulatory and supervisory purview of the FSMIB by Law. Foreign insurers are licensed institutions to undertake insurance business in the FSM. Based on FSMIB data, the conventional insurance sector generated a total premium collection of 3.2 million US Dollars for life and non-life during 2019.

⁴ Japanese companies domiciled and incorporated in the FSM.

⁵ An insurance agent is defined by the FSMIB as a person with the authority of an insurer to solicit application, receive proposals, receive premiums, deliver policies, and to make contracts of insurance.

⁶ A broker is defined by the FSMIB as a person who acts on behalf of a prospective customer and with the prospective customer’s authority to arrange insurance business with insurers, including making proposals and paying premiums.

- **Captive Insurance was introduced with Public Law 14-88 which was enacted in 2006.** Captive insurers are specialized insurance companies that are established for the purpose of insuring only the risk of parent and affiliated companies. More than \$600 million in reinsurance premium were collected by captive insurers during 2019.
- **ASC Trust, a Guam based private pension fund is operating in FSM.** The company is not regulated by the FSM authorities.

DETAILED TECHNICAL ASSESSMENT AND RECOMMENDATIONS

A. Consolidation Basis and Institutional Coverage

21. FSIs for DTs are compiled using a “domestic location” (DL) basis, which is appropriate based on FSM’s banking system structure.⁷ The DL basis, defined in *the FSI Guide*, includes data for resident DTs along with resident branches of foreign deposit takers. Although *the FSI Guide* recommends using a “cross-border, cross-sector, domestically incorporated” (CBCSDI) basis, it also recognizes a second option; the DL basis as an alternative, for countries with DTs that have (i) very few or no foreign branches or subsidiaries, and (ii) very few or no cross-sector subsidiaries.

22. Data compiled using DL basis are of analytical interest because deposit takers resident in a domestic economy provide services, offer savings opportunities to the public, and allocate funds. Resident deposit takers’ actions both affect and are affected by the domestic economy. If resident banks fail to undertake their financial intermediation activity, there could be detrimental consequences for the domestic economy.

23. FSIs for DTs cover 2 domestically incorporated commercial banks. The remainder of the sector that is not covered includes the five credit unions, which are not under the supervision of the FSMBB.

24. Recommendation:

- *The FSMBB to begin regular reporting of FSIs for deposit takers according to the 2019 FSI Guide using the workbook developed during the mission.*

B. Accounting and Regulatory Frameworks Underlying the FSI Data

25. Pursuant to sections 604 and 605 of the FSM Bank Act, the FSMBB is authorized to require banks in the FSM to submit regular and special reports. Banking Supervision Policy

⁷ DL was named as “Domestic Consolidation” (DS) in the *2006 FSI Guide*.

No.1 (Call Reports) issued in August 8, 1995 requires banks to submit certain call reports to the FSMBB with the purpose of providing the FSMBB with prudential and statistical information deemed necessary to fulfill its supervisory responsibilities.

26. Commercial banks prepare their financial statements in accordance with United States Generally Accepted Accounting Principles (US GAAP). A consistent set of accounting principles is required for compiling position and flow data for calculating financial soundness indicators (FSIs) and is a precondition for aggregating data from different institutional units within a sector of an economy. The FSM Banking Act does not stipulate a specific accounting standard for the preparation of financial statements. On the other hand, the Banking Supervision Policy No. 1 dated 1995 specifies that call reports should be prepared in accordance with generally accepted accounting principles. Accordingly, commercial banks prepare and share with the FSMBB their financial statements and call reports in line with US GAAP.

27. Loans are classified as nonperforming when one or more contractual payments of interest or principal are past due for 90 days or more. The definition for “Nonperforming” credit facilities is provided in the Conditions of License (CoL) documents. Nonperforming loans must be classified in accordance with the “Substandard”, “Doubtful” and “Loss” categories. Similarly, “Standard”, “Special Mention”, “Substandard”, “Doubtful” and “Loss” categories are also defined in the CoL documents together with minimum specific provisioning requirements for “Substandard”, “Doubtful” and “Loss” categories (Table 3) of 20, 50 and 100 percent respectively.. The CoL documents for banks do not specify general provisions for performing asset categories (i.e., “Standard” and “Special Mention”) and do not introduce past due date backstops for the asset categories. The FSMBB is cooperating with PFTAC and IMF’s Legal Department with regards to updating credit classification and provisioning rules.

28. Commercial banks classify financial assets in accordance with US GAAP. US GAAP requires financial instruments to be valued at fair value through net income, available for sale (fair value through other comprehensive income), and held to maturity (amortized cost).

29. The FSMBB has not introduced a regulatory framework for the computation of capital adequacy ratios for the commercial banks. The capital adequacy ratio requirement for the domestic bank is introduced through the CoL documents. Accordingly, the bank is required to maintain a 15 percent Tier-1 Capital Adequacy Ratio. Risk Weighted Assets (RWA) are calculated as required for reporting to the FFIEC Call Report Form 041. To enable the FSMBB to monitor capital adequacy in compliance with the Conditions of License, the bank is required to provide a copy of the FFIEC Call Report Form 041 with the FSMBB.

Table 3. FSM: Loans Classification and Provisioning Rules for Commercial Banks

| Loan Classification | Definition | Minimum Provisions Prescribed (in percent) |
|------------------------|---|--|
| Standard | Credit facilities are those that present an acceptable degree of credit risk, i.e. those exposures having a legal purpose and for which repayment may be reasonably expected in the normal course. | - |
| Special Mention | Credit facilities are those where there is a potential weakness presenting a higher level of credit risk than “standard” credits, but less risky than substandard assets. Weaknesses in this category usually stem from poor structuring or deterioration in factors affecting the credit which the Bank believes are correctible in the near term or are short-lived, and usually would be resolved within three to six months without expectation of loss. | - |
| Substandard | Credit facilities are those where there is a definable weakness or weaknesses that jeopardize the full repayment of the debt and there exists a distinct possibility that the Bank may suffer some loss of either principal or interest if the deficiencies are not corrected promptly. Perceived weakness may be in paying capacity (cash flows) or of collateral pledged, if any. The Bank should classify any facilities that are dependent upon its accessing and liquidating the collateral to obtain repayment. | 20 |
| Doubtful | Credit facilities are those where, in addition to the definable credit weakness of a Substandard classification and on the basis of the currently known facts, conditions and values, the collection or liquidation of the debt in full is highly questionable and improbable. | 50 |
| Loss | Credit facilities are those credit facilities where on the basis of current facts, they are considered uncollectible, or of insufficient current value to warrant being maintained as a bankable asset. There is little or no prospect of near-term improvement and no significant realistic strengthening action pending. | 100 |

30. Tier-1 capital for the regulatory requirements is defined in the Call Reports. Tier-1 capital is defined in the Call Report No.3 as equity capital adjusted by deducting goodwill and other intangible assets, current year's operating losses after tax, where not already deducted from equity capital and the amount of any loans classified as Loss, to the extent that such loans have not been fully charged off against specific provisions in full. With the support of TA by PFTAC and the IMF's Legal Department, internal work is ongoing concerning the adoption of the Basel-III definition for regulatory capital. This could help align the regulatory capital definition with Basel standards and introduce the Common-Equity Tier-1 capital definition that could help with reporting the new financial soundness indicators that are introduced with the new FSI Guide.

31. The FSMBB call reports do not define Tier 2 capital. Therefore, Tier-1 capital is equal to total regulatory capital. Items such as undisclosed reserves and asset revaluation reserves, which are components of Tier-2 capital under Basel-I framework, are excluded from total regulatory capital.

32. The CoL documents require a 6 percent minimum leverage ratio to be maintained at all times by the domestic bank. The leverage ratio is defined as Tier 1 Capital / Total Assets. Call Report No.3 provides the basis for leverage ratio reporting to the FSMBB. Total assets are defined as total assets of the bank as of reporting date adjusted by deducting all items which are also required to be deducted from Tier-1 capital.

33. FSMBB has not introduced regulations or reporting requirements for liquidity risk, large exposures, or market risk (i.e., net open position in foreign currency calculation). For the effective oversight of the banking sector it is important for the FSMBB to enhance its regulatory and reporting framework with respect to measurement and supervision of liquidity risk, market risk and large exposures.

C. Source Data

34. The mission examined the source data for compiling FSIs for DTs and identified some gaps that need to be addressed. The source data for compiling FSIs for DTs (i.e., commercial banks) include income and expense statements, the balance sheets and other call reports that are relevant for compiling supervisory series relating to capital adequacy leverage ratio, deposit structure, nonperforming assets, and provisioning. Data used in the compilation of FSIs are reported on a quarterly basis. Quarterly call reports are due within 30 days of the end of the reporting period. FSIs for deposit takers in the FSM are calculated using the reporting forms provided in Table 4.

Table 4. FSM: Reporting Forms

| Report | Coverage | Frequency |
|-----------------|--|-----------|
| Report No. 1 | Consolidated Balance Sheet | Quarterly |
| Schedule No.1A | Loans, Leases and other Extensions of Credit | Quarterly |
| Schedule No. 1B | Deposits | Quarterly |
| Report No. 2 | Off-Balance Sheet Activity | Quarterly |
| Report No. 3 | Capital Adequacy Analysis (Local Bank Only) | Quarterly |
| Report No. 5 | Criticized Assets | Quarterly |
| Report No. 6 | Consolidated Statement of Income and Expenses | Quarterly |
| Schedule No. 6A | Supplemental Detail to Consolidated Statement of Income and Expenses | Quarterly |

35. The FSMBB needs to strengthen the validation of data submitted by banks and further enhance guidance to banks on how to report the different line items in the call reports. While the overall quality of the data is good, the mission found some discrepancies across the different call reports that need to be addressed, notably:

- a. The provisioning figures in the criticized assets call reports do not match those in the balance sheets for certain periods;
- b. The weighted average lending rate and weighted average deposit rate data are missing for some banks;
- c. Deposits reported under Supplementary Schedule 1B do not always align with the data provided in the balance sheet.

36. Recommendation:

- *The FSMBB to implement quality control checks for data submitted by commercial banks and closely work with them to explain the reporting requirements and resolve data discrepancies.*

37. The FSMBB has significantly increased its capacity to collect and process data in recent years. In the past, there was a significant lag in the data reporting to the IMF. Recent efforts by the FSMBB to collect and process data quickly made it possible to share timely data with relevant counterparties. The FSMBB still collects data in hard copy format; electronic data collection could further enhance the timeliness and quality of the data.

38. Recommendation:

- *The FSMBB to start collecting call reports electronically.*

D. Compilation Framework

39. The mission developed compilation spreadsheets to derive FSIs from source data (aggregated income statement, balance sheet, and other supervisory series) for DTs. This process involved mapping source data to the IMF's FSI sectoral financial statement template and deriving the indicators for the sectoral financial statements in the template, to minimize manual work and errors. The mapping of the income and expense statement, balance sheet, and supervisory data was conducted based on the methodology of the 2019 Guide using bridge tables. The bridge tables show where each item in the income and expense statement, balance sheet or other call reports are classified, serving as a useful reference for compilers. The compilation spreadsheets, including the bridge tables, were provided to the FSMBB. This compilation framework will ensure a smooth FSI compilation.

40. The mission assisted the FSMBB in the compilation of 11 core FSIs and 7 additional FSIs for deposit-takers as well as two additional FSIs relating to the size of OFC subsectors.

These indicators were compiled for dissemination based on the list of core and additional indicators in *2019 FSIs Guide*. The core FSIs for deposit-takers that were not compiled are common equity tier 1 capital to risk-weighted assets, the liquidity coverage ratio, the net stable funding ratio, the net open position in foreign exchange to capital, liquid assets to short term liabilities and residential and commercial real estate prices. Additional FSIs that were not available include large exposures to capital, the spread between reference lending and deposit rates, the spread between highest and lowest interbank rate, the geographical distribution of loans to total loans and credit growth to the private sector. Although the new core FSI on provisions to nonperforming loans was not compiled, it can be calculated by taking specific provisions divided by nonperforming loans. Some of the FSIs that were not compiled are yet to be implemented in the new report forms currently under development by STA.

41. The main differences between the existing FSIs compiled by the FSMBB and those developed during the mission stem from compilation methodologies. The FSIs compiled by the mission were based on the recommended compilation methodologies of the *2019 FSI Guide*. This included the disaggregation of specific provisions from total loan loss provisions, categorizing claims of one deposit taker from another as interbank loans, the annualization of income and expenditure figures, and the use of average capital and total assets figures where appropriate. Other differences are explained in Appendix III.

Income Statement

42. The income and expense statement in the call reports are used to map revenue and expenses to the FSI report forms. The mission identified that according to call report No. 6 dividends on investments are categorized under interest income whereas the 2019 FSI Guide

recommends dividends declared payable by other corporations or cooperatives in which DTs have an equity stake to be covered under non-interest income (i.e., "other income"). Chapter 6 section 618 of the FSM Banking Law, however, prohibits domestic banks to invest in the stock of any other corporation.

43. The mission explained the annualization of net income before tax and the averaging of total assets and capital and reserves in the computation of return on assets (ROA) and return on equity (ROE). The *2019 FSI Guide* recommends using net profit before tax for calculation of the ROA and net income after tax for calculating of ROE. Accordingly, ROA is calculated using the annualized net income before tax divided by average total assets, while ROE is calculated using the annualized net income after tax divided by total equity. The preferred methods for annualization and averaging of quarterly data were explained to the staff of the FSMBB as follows (e.g., for 2019):

- Annualizing net income before/after tax reported on a cumulative basis: 2019Q1 = (2019Q1)*4; 2019Q2 = (2019Q2)*2; 2019Q3 = (2019Q3)/3*4; 2019Q4 = (2019Q4).
- Averaging total assets and capital: 2019Q1 = (2018Q4+2019Q1)/2; 2019Q2 = (2018Q4+2019Q1+2019Q2)/3; 2019Q3 = (2018Q4+2019Q1+2019Q2 +2019Q3)/4; 2019Q4 = (2018Q4+2019Q1+2019Q2+2019Q3+2019Q4)/5.

Balance Sheet

44. Deposits with domestic and foreign banks on the asset side of the balance sheet are mapped to interbank loans. This is in line with the recommendation of the *2019 FSI Guide*.

45. Customers deposits are calculated using the Supplementary Schedule No. 1B. *2019 FSI Guide* defines customer deposits as; all deposits placed by residents or nonresidents, except those placed by (resident or nonresident) financial corporations, central governments, or central banks. Consistent with the definition of customer deposits in the *2019 FSI Guide*, deposits from the central government are excluded from customer deposits and mapped to 'other currency and deposits.' Deposits from domestic and foreign banks are mapped to interbank deposits. Due to the absence of disaggregated data on deposits of nonresident non-bank financial corporations, it was decided, after consultation with the FSMBB staff, to map nonresident-nonbank deposits to customer deposits until more granular data to be obtained.

46. Recommendation:

- *The FSMBB to align the sectoral classification of deposits (SS 1B form) with the 2019 FSI Guide.*

47. Consolidated balance sheet data report form (Report No. 1) requires reporting of investment and securities together. The FSI reporting templates, on the other hand, require

debt securities to be disaggregated from shares and other equity. As noted before, domestic banks in FSM are prohibited from investing in the stock of any other corporation.

48. Accrual accounting is used by commercial banks to record transactions on their balance sheets, but accrued interest is not included with the value of underlying instrument. In the *Consolidated Balance Sheet (Report No. 1)*, accrued interest is included on the asset side under and on the liability side under *Other Liabilities*. These values are not significant; on the asset side 0.1-0.2 percent of total assets and on the liability side 0.2 percent of total liabilities. The *Guide* recommends including interest costs that have accrued and are not yet payable as part of the value of the underlying instruments. However, currently detailed data are unavailable to map accrued interest to underlying instruments.

49. Recommendation:

- *The FSMBB to collect memorandum items with detail of accrued interest by instrument (Report No. 1).*

50. Loan loss provisions are reported in the Consolidated Balance Sheet (Report No. 1) but disaggregated information on specific and general provisions are not readily available. 2019 FSI Guide defines specific provisions as provisions for loan losses that are set aside to cover identified non-performing loans. The mission estimated specific provisions for non-performing loans by multiplying the amount of substandard, doubtful and loss loans with the corresponding provisioning requirements (i.e., 20, 50 and 100 percent respectively). The aggregate amount found using this approach is categorized as specific provisions and mapped to (18.ii) Specific Provisions line in the *Balance Sheet*. The remaining provisions are categorized as general provisions on performing loans and other assets and are mapped to other liabilities.

51. Recommendation:

- *The FSMBB to collect the data on the amount of specific provisions set aside for nonperforming loans in the Criticized Assets Call Report (Report No. 5).*

52. The FSMBB collects data on accumulated depreciation under 'other liabilities'. However, accumulated depreciation should be considered as a contra asset account, reducing the overall asset value. Accordingly, accumulated depreciation is mapped to '*Nonfinancial Assets*' as a contra asset account, which has affected the size of the balance sheet by reducing the reported total assets by 1.3 percent as of 2020Q2.

53. Capital and reserves data are available through the consolidated balance sheet without additional disaggregation. The consolidated Balance Sheet call report incorrectly defines capital and reserves to include subordinated debt as an element of *Capital and Reserves*. The 2019 FSI Guide defines *Capital and reserves* as the equity interest of the owners in an enterprise and is the difference between total assets and liabilities and include *funds contributed by owners, retained earnings, current year result and general and special reserves*. The FSMBB

needs to clearly distinguish the balance sheet capital and reserves from regulatory capital which is used for the calculation of regulatory capital requirements. It is also important to collect additional information on the subcomponents of *capital and reserves* (i.e., *paid in capital, retained earnings, current year result, general and specific reserves*) which could help building internal validation checks with other reporting forms.

54. Recommendation:

- *The FSMBB to clarify the definition of capital and reserves in the balance sheet and bring it in line with the definition in the 2019 FSI Guide and collect additional information on the subcomponents of capital and reserves (Report No. 1).*

55. The balance sheet does not include financial derivatives. Commercial banks in FSM do not engage in financial derivative activities so the omission has no consequences so far, but banks could start engaging in such activities in the future. The mission advised to include the relevant lines in the balance sheet to be ready to capture this activity when it occurs and reflect it in the FSIs.

56. Recommendation:

- *The FSMBB to revise the balance sheet call report to incorporate financial derivatives on both the asset and liability sides (Report No. 1).*

Supervisory series

Regulatory Capital and Risk Weighted Assets (RWA)

57. The capital adequacy ratios are calculated using the national definition of Tier-1 capital and the FFIEC definition for RWAs. As mentioned earlier, regulatory capital comprises Tier-1 capital only and the definition of Tier-1 capital, provided in the capital adequacy analysis call report (Report No. 3), lacks the clear guidance regarding the elements of capital. Additionally, Report No. 3 does not specify the calculation of risk weighted assets. Currently, risk weighted assets are obtained through the report form *Schedule RC-R Part I – Regulatory Capital Components and Ratios* which is prepared for the FFIEC. The FFIEC call report suggests that the Basel-III approach is used in the calculation of capital adequacy ratios. The FSMBB needs to develop its own report forms and preferred methodologies to calculate risk weighted assets given the possibility that the CFA may not continue beyond 2023.

58. Recommendations:

- *The FSMBB to provide clear instructions to banks to fill-in Tier-1 capital in the call report (Report No. 3).*

- *The FSMBB to introduce a definition of risk weighted assets and the necessary call report to collect additional data on capital adequacy ratios.*

Nonperforming Loans

59. Non-performing loans are defined in the CoL documents for deposit takers as loans for which one or more contractual payments of interest or principal are past due for 90 days or more. The *Criticized Assets* call report (Report No. 5) collects information on non-performing loans according to its subcomponents; substandard, doubtful and loss loans. The 2019 FSI Guide recommends that nonperforming loans should be recorded as gross value of the loan on the balance sheet, not just the overdue amount. On the other hand, Report No. 5 allows loans to be split between the fully secured portion and remaining portion and reporting only the remaining portion under the 'Loss' category. This may lead to underreporting of NPLs. Moreover, the definition of nonperforming loans was not clearly provided in Report No. 5.

60. Recommendation:

- *The FSMBB to provide a definition of nonperforming loans in the criticized assets call report in line with the 2019 FSI Guide and eliminate partial reporting of NPLs based on collateralization (Report No. 5).*

Liquidity indicators

61. The FSMBB does not have a definition of liquid assets. The *2019 FSI Guide* defines liquid assets as comprised of (i) currency; (ii) deposits and other financial assets that are available either on demand or within three months or less; and (iii) securities that are traded in liquid markets (including repo markets) that can be readily converted into cash, with insignificant risk of change in value under normal business conditions.⁸ The components of liquid assets for the calculation of FSIs are derived from the balance sheet and consist of currency, cash items in the process of collection, demand/overnight deposits with local and foreign banks, and securities abroad. The FSMBB staff and bank officials that the mission met with clarified that securities abroad mainly consists of US Treasury and US Government Agency securities. There is no local securities market established in the FSM.

62. Data needs to be collected for short term liabilities. The *2019 FSI Guide* defines short term liabilities as short-term element of DTs' debt liabilities and the net market value of their financial derivatives positions. Short term liabilities are those that could be withdrawn either on demand or within three months or less. Producing this series would require data on the maturity schedule of liabilities. Also, a maturity schedule of assets could be beneficial to obtain in order to analyze the gap structure of the assets and liabilities in the banking system.

⁸ The *2019 FSI Guide* eliminates the distinction between core and broad measures of liquid assets.

63. Recommendations:

- *FSMBB to define liquid assets and collect data in line with the 2019 FSI Guide definition.*
- *The FSMBB to collect information on the maturity profile of assets and liabilities with a specific call report.*

Large Exposures

64. Large exposures are defined as ones where the sum of all exposures of a DT to a counterparty or to a group of connected counterparties are equal to or above 10 percent of the DT's eligible capital base. The FSMBB has not yet introduced a definition for large exposures. With the support of TA by PFTAC and IMF's Legal Department, internal work is ongoing concerning the introduction of a definition of large exposures.

Net open position in foreign currencies

65. The FSI on net open position in foreign currencies to capital can be calculated using either on-balance sheet or on- and off-balance sheet measures, but the latter approach is preferred because it is consistent with the Basel framework. The FSMBB does not require the commercial banks to report their net open positions in foreign currency, but data collected from the memorandum items of the consolidated balance sheets suggest that these exposures are insignificant. The FSMBB should be prepared to require reporting of the relevant data should foreign exposures increase.

Spread between reference lending and deposit rates

66. The FSMBB receives data on average lending and deposits rates through the Supplemental Detail to Consolidated Statement of Income and Expenses call report (Report No. 6.A). The mission identified that data for one bank is missing in the reports. A template is provided by the mission to the FSMBB to calculate the spread between lending and deposit rates financial soundness indicator when the data gap is filled.

67. Recommendation:

- *The FSMBB to calculate the spread between the reference lending and deposit rates using the template provided once the data quality issues are resolved (Report No. 6.A).*

Real estate markets

68. The FSMBB collects data on loans collateralized by real estate. The FSMBB defines real estate credit as any advance for the acquisition and holding of real estate where primary reliance is placed on the real estate as collateral security. The *2019 FSI Guide*, on the other hand, defines *residential real estate loans* as loans that are collateralized by residential real estate and *commercial real estate loans* as loans that are collateralized by commercial real estate, loans to

construction companies or loans to companies active in the development of real estate. FSIs on residential estate loans to gross loans and commercial real estate loans were not compiled as disaggregated data for residential real estate and commercial real estate loans, as defined in the *2019 FSI Guide*, is not readily available.

69. Recommendation:

- *The FSMBB to collect residential real estate and commercial real estate loans data in line with the definitions provided in the 2019 FSI Guide.*

E. New FSI Report Forms

70. The 2019 FSI Guide recommends that extraordinary income/expenses be mapped to other income, if positive, or other expenses, if negative.⁹ Extraordinary items in the income and expense statement (Report No. 6) are mapped accordingly. This treatment will help the FSMBB to transition to the new FSI template when it is implemented in the coming months.

71. Provisions on performing loans and other assets are mapped to other liabilities in the current report forms, consistent with the approach adopted in 2019 FSI Guide.

However, these should be reported under “General and other provisions” on the liability side of the balance sheet when the new FSI report forms are introduced.

72. The 2019 FSI Guide recommends that countries report other comprehensive income (OCI) as an additional line item in their income and expense statements. Other comprehensive income consists mainly of revenues, expenses, gains, and losses that are excluded from net income on the income statement as well as unrealized gains and losses on financial instruments that are categorized under available-for-sale. Commercial banks in the FSM report other comprehensive income in their financial reports.

73. Recommendation:

- *The FSMBB to collect other comprehensive income (OCI) data.*

F. FSI Metadata

74. The mission highlighted the need to complement the FSI data with the corresponding metadata. Metadata reporting is important for interpreting the FSIs and to allow for cross-country comparisons. Any deviations from the recommendations of the *2019 FSI Guide* should be explained in the metadata and updated when necessary. The metadata should contain information on the content and coverage of the FSIs, as well as the accounting conventions and

⁹ International Accounting Standards (IAS) no longer allows the reporting of extraordinary items in the presentation of profit or loss or other comprehensive income statements.

other national guidelines. The mission developed FSI metadata for DTs and two additional FSIs on the size of OFC subsectors based on information provided by the authorities. The metadata should be updated whenever changes are observed, for instance, when there are changes to the accounting and regulatory frameworks or to the call report instructions underlying the FSI source data.

75. The understanding of the calculation of key underlying series is important for better interpretation of FSIs. Although the *2019 FSI Guide* provides guidance on the calculation of the underlying FSI series, the calculation of some data series used by national FSI compilers may not always be fully in line with the *2019 FSI Guide* due to lack of data. Furthermore, there might be some adjustments to the underlying series for the FSI calculation. The *2019 FSI Guide* also defers the calculation of some underlying series to national practices. Appendix IV presents the detailed FSI metadata for deposit takers for reference. The mission also prepared the FSI metadata Excel file for reporting together with the FSI data to STA for posting on the IMF's FSI website.

G. FSI Data and Metadata Reporting

76. The FSMBB aims to regularly report the sectoral FSIs to the IMF with quarterly frequency, to be posted on the IMF's FSI website, upon the FSMBB management's approval. As discussed earlier, the FSMBB can compile and report all 11 core and 7 additional FSIs for deposits-takers as well as two additional FSIs on the size of OFC subsectors on a quarterly basis. Underlying data available at the FSMBB for the calculation of FSIs starts from 2006. The mission worked with FSMBB officials to complete the FSI institutional coverage template (FS1 template) with information on the number of the reporting DTs and their branches, split by ownership, and their respective total assets. The FS1 template should also be reported to the IMF for dissemination.

77. Recommendations:

- *The FSMBB to finalize and report to STA for review the FSI sectoral financial statements (FS2 template) for DTs, including balance sheet, income statement, and memorandum series, the sectoral FSIs with underlying series (FSD template) for DTs with quarterly data beginning from 2006:Q1, the FSI institutional coverage (FS1 template) with annual data starting from 2006, and the FSI metadata (FSM template).*
- *The FSMBB to start regular reporting to STA, for posting on the IMF's FSI website, of the FSD and FS2 templates with quarterly data starting from 2006:Q1, and the FS1 template with annual data starting from 2006. Also report the FSM template periodically.*

H. FSIs for Other Sectors

78. Two FSIs for OFCs, namely, OFC financial assets to total financial assets and OFC financial assets to gross domestic product, were compiled during the mission. The OFC sector, solely composed of the FSMDB, currently accounts for 15 percent of the reported assets of the financial system. Data on total assets for the insurance sector was unavailable to the mission. The mission advised that developments in the OFC sector be monitored given the importance of the FSMDB in extending credit to the local economy and the importance of the captive insurance sector.

I. Resources, Training, and Technical Cooperation

79. The mission recommended that FSMBB staff seek to attend regional and HQ training courses on financial sector statistics. STA has in the past regularly delivered courses on both MFS and FSI at IMF headquarters (each course once every two years), and regional trainings are also scheduled. Details can be found on the webpage of the IMF's Institute for Capacity Development.

80. Recommendation:

- *Support FSMBB officials' efforts to participate in IMF FSI training courses to improve their methodological knowledge and skills in compilation and interpretation of FSIs.*

J. Other Issues

81. The mission discussed with the FSMBB options for the reporting of Monetary and Financial Statistics (MFS). The FSM is one of the few countries still reporting MFS data to STA via non-standardized report forms. The FSMBB officials are informed on the importance of sharing MFS data through standardized report forms.

82. The mission also inquired about the status of the FSM's Financial Access Survey (FAS) reporting. FSM is a timely reporter to the FAS, but has the capacity to report more series. The FSMBB currently reports 29 series, mainly focused on commercial banks data, out of the 121 series that are part of the FAS. The FSMBB is encouraged to increase the coverage of indicators by incorporating other financial institutions (i.e., credit unions), data disaggregated by gender, as well as mobile and internet banking.

Appendix I. FSM: Financial Soundness Indicators

| | Dec-16 | Jun-17 | Dec-17 | Jun-18 | Dec-18 | Jun-19 | Dec-19 | Jun-20 |
|---|------------|--------|--------|--------|--------|--------|--------|--------|
| Core FSIs | In percent | | | | | | | |
| Regulatory capital to risk-weighted assets | 24.79 | 27.03 | 35.47 | 37.63 | 33.27 | 33.89 | 35.24 | 34.22 |
| Regulatory Tier 1 capital to risk-weighted assets | 24.79 | 27.03 | 35.47 | 37.63 | 33.27 | 33.89 | 35.24 | 34.22 |
| Nonperforming loans net of provisions to capital | 10.35 | 7.96 | 3.75 | 3.77 | 3.25 | 1.63 | 1.93 | 1.17 |
| Nonperforming loans to total gross loans | 1.08 | 0.69 | 0.35 | 0.36 | 0.31 | 0.17 | 0.33 | 0.58 |
| Sectoral distribution of loans | | | | | | | | |
| Residents | 17.69 | 14.95 | 17.16 | 15.90 | 17.15 | 16.06 | 17.22 | 15.14 |
| Deposit-takers | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Central bank | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Other financial corporations | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| General government | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Nonfinancial corporations | 17.40 | 14.70 | 16.92 | 15.69 | 15.39 | 14.47 | 15.56 | 13.69 |
| Other domestic sectors | 0.28 | 0.25 | 0.25 | 0.22 | 1.76 | 1.59 | 1.66 | 1.46 |
| Nonresidents | 82.31 | 85.05 | 82.84 | 84.10 | 82.85 | 83.94 | 82.78 | 84.86 |
| Return on assets | 1.03 | 1.06 | 1.05 | 1.58 | 1.80 | 1.97 | 1.98 | 1.19 |
| Return on equity | 13.91 | 15.35 | 15.18 | 23.07 | 25.59 | 26.99 | 26.23 | 15.45 |
| Interest margin to gross income | 83.01 | 84.55 | 84.13 | 86.35 | 86.98 | 87.04 | 86.59 | 86.45 |
| Noninterest expenses to gross income | 65.28 | 58.92 | 56.42 | 53.03 | 49.77 | 46.92 | 46.95 | 57.55 |
| Liquid assets to total assets | 56.44 | 55.24 | 58.64 | 55.79 | 61.12 | 59.57 | 62.24 | 59.10 |
| Additional FSIs | | | | | | | | |
| Capital to assets | 6.29 | 5.95 | 6.21 | 5.84 | 6.02 | 5.98 | 6.11 | 5.95 |
| Gross asset position in financial derivatives to capital | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Gross liability position in financial derivatives to capital | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Trading income to total income | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Personnel expenses to noninterest expenses | 44.49 | 46.23 | 45.34 | 46.22 | 45.57 | 45.23 | 45.88 | 48.94 |
| Customer deposits to total (noninterbank) loans | 376.4 | 429.9 | 416.3 | 456.1 | 422.0 | 451.0 | 418.6 | 471.3 |
| Foreign-currency-denominated loans to total loans | 1.89 | 0.71 | 0.00 | 0.00 | 0.00 | 0.16 | 0.16 | 0.14 |
| Foreign-currency-denominated liabilities to total liabilities | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| OFCs | | | | | | | | |
| OFC's financial assets to total financial assets | 14.72 | 14.73 | 15.38 | 14.18 | 14.38 | 13.97 | 14.85 | 14.44 |
| OFC's financial assets to gross domestic product | 16.04 | | 17.77 | | 14.93 | | | |
| Source: TA Mission | | | | | | | | |

Appendix II. Officials Met During the Mission

| Name | Title | Institution |
|-----------------------|--------------------------|---|
| Jesse Giltamag | Banking Commissioner | Federated States of Micronesia Banking Board |
| Pilika Palik | Bank Examiner | Federated States of Micronesia Banking Board |
| Molleighann Cornelius | Financial Analyst | Federated States of Micronesia Banking Board |
| Rose Nakanaga | Vice President | Bank of Federated States of Micronesia |
| Christopher Schramm | Vice President | Bank of Federated States of Micronesia |
| Mary Simmering | Assistant Vice President | Bank of Guam - Pohnpei Branch |
| Christine Quichocho | Vice President | Bank of Guam – Headquarters |
| Loreta Gabalunos | Assistant Vice President | Bank of Guam – Headquarters |
| Desiree Iglesias | Accounting Officer II | Bank of Guam – Headquarters |
| Frank Quitugua III | Accounting Officer | Bank of Guam – Headquarters |

Appendix III. Summary of Recommended Amendments to the FSI Definitions

The mission recommended the following amendments to align FSIs with the *FSI Guide* (Appendix III. Table 1). The recommended amendments include both improvements discussed in this report, as well as the incorporation of amendments brought by the *2019 FSI Guide*. While most changes were implemented during the mission and will not require further work, those changes requiring a longer timeframe for implementation are bolded in the table and spelled out as individual recommendations in this report.

Appendix III. Table 1. FSM: Recommended Amendments to FSIs

| Indicator | Recommendation |
|--|--|
| Total Capital to RWA / Tier 1 Capital to RWA | Provide clear instructions to banks to guide properly fill-in their Tier-1 capital in the call report and introduce risk weighted assets definition and necessary call report to collect additional reporting on capital adequacy ratios. (to be implemented) . |
| NPLs net of provisions to capital | Subtract only specific provisions from the numerator. Provisions include only specific provisions on nonperforming loans. Use regulatory capital as the denominator. |
| NPLs to total loans | The definition of total loans should be aligned with the FSI Guide definition. |
| Sectoral distribution of loans | Categorize claims of one deposit taker on another as interbank loans. |
| Return on Assets (ROA) | Use net income before tax in the numerator. Aggregate the numerator as indicated in the report. Average the denominator as indicated in the report. |
| Return on Equity (ROE) | Use net income after tax in the numerator. Aggregate the numerator as indicated in the report. Average the denominator as indicated in the report. |
| Interest margin to gross income | No change |
| Noninterest expense to gross income | Update noninterest income definition as suggested in the report. |
| Liquid assets to total assets | Introduce a liquid assets definition in line with the 2019 FSI Guide and collect liquid assets data. Use liquid assets derived |

| Indicator | Recommendation |
|---|--|
| | from the balance sheet until more granular data is available (to be implemented) . |
| Liquid assets to short-term liabilities | Collect information on the maturity profile of assets and liabilities with a specific call report. (to be implemented) . |
| Net open position in foreign exchange to capital | Collect data as recommended by the <i>2019 FSI Guide</i> (to be implemented) . |
| Capital to Assets | Correct total assets with accumulated depreciation. Collect specific provisions data. (to be implemented) . |
| Large exposures to capital | Collect data as recommended by the <i>2019 FSI Guide</i> (to be implemented) . |
| Gross asset/liability position in derivatives to capital | Use regulatory capital as the denominator. |
| Trading income to total income | No change. |
| Personnel expenses to noninterest expenses | Update noninterest expenses definition as suggested in the report. |
| Spread between reference lending and deposit rates (basis points) | Use the template provided during the Mission to calculate the indicator once complete data is available (to be implemented) . |
| Customer deposits to total non-interbank loans | Align the sectoral classification of deposits with that of the <i>2019 FSI Guide</i> (to be implemented) . |
| FX loans to total loans | No change. |
| FX liabilities to total liabilities | No change. |
| Residential real estate loans to total loans | Collect data as recommended by the FSI Guide (to be implemented) . |
| Commercial real estate loans to total loans | Collect data as recommended by the FSI Guide (to be implemented) . |

These data and methodological revisions have resulted in significant changes to some FSIs. The mission recommended to the FSMBB to update the calculation of FSIs in line with the *2019 FSI Guide*. Appendix III. Table 2 covers the size of change observed in the FSIs before and after

the mission. According to this table, there have been significant changes in the capital adequacy ratios, *NPL ratios*, sectoral distribution of loans, return on equity and liquid assets indicators.

Appendix III. Table 2. FSM: Comparison of FSIs Before and After the Technical Assistance

| | FSI Mission | | FSMBB Calculation | | Difference | |
|---|-------------|--------|-------------------|--------|------------|--------|
| | Dec-17 | Dec-18 | Dec-17 | Dec-18 | Dec-17 | Dec-18 |
| Core FSIs | | | | | | |
| Regulatory capital to risk-weighted assets | 35.47 | 33.27 | 39.10 | 33.30 | -3.63 | -0.03 |
| Regulatory Tier 1 capital to risk-weighted assets | 35.47 | 33.27 | 39.14 | 33.27 | -3.68 | 0.00 |
| Nonperforming loans net of provisions to capital | 3.75 | 3.25 | -4.18 | -6.29 | 7.93 | 9.54 |
| Nonperforming loans to total gross loans | 0.35 | 0.31 | 1.28 | 1.21 | -0.93 | -0.90 |
| Sectoral distribution of loans | | | 0.00 | 0.00 | 0.00 | 0.00 |
| Residents | 17.16 | 17.15 | 69.66 | 66.52 | -52.49 | -49.37 |
| Deposit-takers | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Central bank | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Other financial corporations | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| General government | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Nonfinancial corporations | 16.92 | 15.39 | 1.01 | 6.83 | 15.91 | 8.55 |
| Other domestic sectors | 0.25 | 1.76 | 68.65 | 59.68 | -68.40 | -57.92 |
| Nonresidents | 82.84 | 82.85 | 30.34 | 33.48 | 52.49 | 49.37 |
| Return on assets | 1.05 | 1.80 | 1.30 | 1.82 | -0.25 | -0.02 |
| Return on equity | 15.18 | 25.59 | 18.54 | 25.05 | -3.36 | 0.54 |
| Interest margin to gross income | 84.13 | 86.98 | 84.13 | 86.98 | 0.00 | 0.00 |
| Noninterest expenses to gross income | 56.42 | 49.77 | 53.91 | 47.59 | 2.51 | 2.18 |
| Liquid assets to total assets | 58.64 | 61.12 | 66.30 | 61.56 | -7.67 | -0.45 |
| Additional FSIs | | | 0.00 | 0.00 | 0.00 | 0.00 |
| Capital to assets | 6.21 | 6.02 | 6.79 | 5.97 | -0.58 | 0.05 |
| Gross asset position in financial derivatives to capital | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Gross liability position in financial derivatives to capital | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Trading income to total income | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Personnel expenses to noninterest expenses | 45.34 | 45.57 | 47.46 | 47.66 | -2.11 | -2.09 |
| Customer deposits to total (noninterbank) loans | 416.36 | 422.09 | 409.26 | 417.01 | 7.10 | 5.08 |
| Foreign-currency-denominated loans to total loans | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Foreign-currency-denominated liabilities to total liabilities | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| OFCs | | | | | | |
| OFC's financial assets to total financial assets | 15.38 | 14.38 | | | | |
| OFC's financial assets to gross domestic product | 17.77 | 14.93 | | | | |
| Other Indicators Previously Submitted to the STA | | | | | | |
| Liquid assets to short-term liabilities | NA | NA | 240.04 | 240.35 | NA | NA |
| Net open position in foreign exchange to capital | NA | NA | 0.00 | 0.00 | NA | NA |
| Large exposures to capital | NA | NA | 126.47 | 132.74 | NA | NA |
| Residential real estate loans to total gross loans | NA | NA | 0.00 | 0.00 | NA | NA |
| Commercial real estate loans to total gross loans | NA | NA | 27.44 | 25.41 | NA | NA |

Sources: TA Mission and FSMBB

Appendix IV. FSI Metadata for Deposit Takers

Financial Soundness Indicators Metadata for FSM

Metadata should be disseminated together with FSI data to facilitate data interpretation. Metadata include information about FSIs and their compilation, such as data definitions, how data are consolidated, supervisory and accounting rules adopted by the reporting banks, institutional coverage, and data sources, which are useful to data users.

Residence of institutional units

Foreign-owned companies incorporated in FSM are classified as residents in line with System of National Accounts (2008 SNA), which classifies foreign-owned companies as residents in an economic territory where they engage in and intend to continue engaging in economic activities and transactions on a significant scale for at least one year.

Consolidation basis

FSIs for deposit takers (DTs) in FSM are compiled on a domestic location (DL) basis. According to the *2019 FSI Guide*, DL includes resident DTs along with their branches and subsidiaries in the same sector that are also resident in the domestic economy.

Consolidation adjustments

Banks in FSM do not have deposit taking subsidiaries. Therefore, intra-group consolidation adjustment is not applicable. Intragroup adjustments refer to the elimination of financial flows (income and expense) and financial positions between DTs within the same banking group (parent, its branches, and subsidiaries).

Institutional coverage

FSIs for DTs cover two commercial banks that are under the purview of the FSMBB. Credit unions, which are deposit taking institutions are not regulated by the FSMBB and not included in the FSI compilation.

Regulatory framework

Capital adequacy calculation follows a Basel I approach for the definition of regulatory capital and Basel-III approach for the definition of risk weighted assets. A 15 percent Tier-1 capital adequacy ratio and 6 percent leverage ratio is required by the FSMBB.

Accounting framework

Commercial banks in FSM have adopted US GAAP for the preparation of financial statements that are used for compiling FSIs. Accrual accounting is adopted, and accrued interest is calculated. Interest is not accrued on nonperforming loans.

Data Definitions

Tier 1 capital consists of equity capital adjusted by deducting goodwill and other intangible assets, current year's operating losses after tax, where not already deducted from equity capital and the amount of any loans classified as Loss, to the extent that such loans have not been fully charged off against specific provisions in full.

Total regulatory capital is equal to Tier 1 capital. The FSMBB does not prescribe any element of Tier 2 capital.

Risk Weighted Assets is calculated as required for reporting on the FFIEC Call Report Form 041.

The broad measure of liquid assets include currency, cash items in the process of collection, demand/overnight deposits with local and foreign banks, and securities abroad.

Nonperforming loans (NPLs) is defined as loans for which one or more contractual payments of interest or principal are past due for 90 days or more.

Return on assets (ROA) is calculated as the ratio of annualized net income before tax divided by average total assets.

Return on equity (ROE) is calculated as the ratio of annualized net income after tax divided by average capital and reserves.

Source data

Source data for compiling FSIs for DTs include income and expense statements, the balance sheets and other call reports that are relevant for compiling supervisory series relating to definition of capital, deposit breakdown and nonperforming loans. Banks are required to submit quarterly returns by the 30th day after the end of each quarter.