

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

The Honorable Isaac V. Figir
Speaker, Sixteenth Congress
Federated States of Micronesia
Second Special Session, 2009

Dear Mr. Speaker:

Your Committee on Resources and Development, to which was referred
C.B. NO. 16-05 entitled:

"A BILL FOR AN ACT TO AMEND TITLE 29 OF THE CODE OF THE FEDERATED STATES OF MICRONESIA BY MODIFYING SECTIONS 402, 404 AND 405, TO SET A SEPARATE TREATMENT OVER APPLICATION OF FOREIGN BANKS SEEKING TO ESTABLISH A NEW BRANCH IN THE FSM AS OPPOSED TO FIRST-TIME APPLICATIONS FOR ISSUANCE OF A LICENSE; MODIFYING SECTION 612 TO ALTER THE LOAN EXPOSURE CEILING IMPOSED ON BANKS; AND TO CHANGE SECTION 613 IN ORDER TO INCREASE THE LIMIT THAT A BANK MAY LOAN ITS OFFICER, DIRECTOR, AGENT, EMPLOYEE AND/OR RELATED PERSON; AND FOR OTHER PURPOSES."

begs leave to report as follows:

The intent and purpose of the bill are expressed in its title.

The amendments in C.B. No. 16-05 basically serve to:

1. Reduce the requirements for a foreign bank already in the FSM wishing to open an additional branch;
2. Allow a domestic bank to encumber over 20% of its capital in certain transactions and securities; and
3. Increase the limitations on loans by related person for domestic banks from \$5,000 to \$25,000.

Your Committee held public hearings on June 9, 2009, June 10, 2009 and September 14, 2009 for discussions on the proposed amendments to the Bill. Present at these hearings were Chairman, Roger Mori; Vice Chairman, Tony H. Otto; Senator, Dion Neth; Senator, Dohsis Halbert; Wilson F. Waguk, Banking and Insurance Commissioner; Jessee Giltamag, Insurance Examiner; Mary Simmering, Bank Examiner; Patrick Mackenzie, BFSM VP; Vida Ricafrente, VP/Branch Manager Bank of Guam; Stephen Finnen, Bank of FSM Attorney; Robert De Courteney, BFSM President/CEO; Larry Adams, Chairman BFSM Board; Ihlen K. Joseph, Vice Chairman BFSM Board; Disko Jack, Operations Officer Bank of Guam; Jun Bacalando Jr., from the Department of Justice; Pelsesar Petrus, Special Assistant to the President; Edgar Santos, General Manager of the Pohnpei Visitor's

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

Bureau; Lam Dang, Legislative Counsel and Marsha R. Kennedy, Staff Attorney.

The FSM Banking and Insurance Board provided a very helpful matrix to the Committee on the bill indicating the present language, proposed language, rationale for change and remarks.

Mr. Bacalando, of the Department of Justice, stated that the amendments to C.B. No.16-05 have been necessitated by the banking industry.

1. Reduce the requirements for a foreign bank already in the FSM wishing to open an additional branch

Mr. Waguk, Banking and Insurance Commissioner, noted that the changes in §402 would apply to the Bank of Guam who wishes to open branches in two more states without completing the licensing requirement again.

Larry Adams, Chairman of the Bank of the FSM proposed that the amendments to C.B. No. 16-05 be struck in their entirety since they will have a greater effect on the Bank of FSM than any other bank in the country by allowing any bank to expand with little more than notice. Mr. Adams believes that a bank's financial situation may have greatly changed since their initial application. Since the Bank of the FSM's expansion must be carefully reviewed by the FDIC, he believes that other banks should also be scrutinized when they wish to open an additional branch. Mr. Adams also stated that the application for expansion should go through the entire application process where the FSM Banking Board should supervise and make sure that the opening of a new branch is in the best interest of the FSM government and of the citizens of the FSM.

Steve Finnen, Attorney for the Bank of the FSM pointed out, if these amendments were to pass, that a bank might be able to expand into additional states for beyond what their original country of incorporation might have authorized.

Robert De Courteney, President and CEO of the Bank of the FSM stated that there should be due diligence completed for all banks wishing to open additional branches in the country.

The matrix provided to the Committee by the Banking and Insurance Board state that the rationale/justification for this change is that, **"[t]he board believes that Chapter 4 should not apply to new branches of existing foreign banks operating in the FSM as that could be construed that separate license[s] need to be obtained."** [emphasis added] The remarks in the Board's matrix state that, **"[s]ection 402 can be read as requiring a permit to be issued and a separate license**

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

for additional branches but this process adds nothing and could cause unnecessary frustration to the banks." [emphasis added]

In contradiction to this, the Banking and Insurance Commissioner, at the September meeting, stated that (under current law) a foreign bank with a branch already in the FSM can set up a branch in the FSM by not going through the ten requirements or conditions. Section 402 of Title 29 and the prior testimony and matrix provided by the Banking and Insurance Board contradict the Commissioner's September statements by showing that the amendments will act to **reduce** the requirements for a foreign bank wishing to open addition branches within the FSM.

Your Committee has determined that there are already provisions in the law to accomplish the amendments proposed under this section. This is a repetition of the law. Furthermore, this issue is now moot.

2. Allow a domestic bank to encumber over 20% of its capital in certain transactions and securities including:

- a. Transactions with members of the FDIC
- b. Securities issued by or explicitly guaranteed by the US government
- c. Secured indebtedness or liabilities which cannot be removed without bank approval
(new subsection) case-by-case written exceptions given by the Board

Mr. Bacalando noted that the 20% cap is to ensure that the loans are safe. The Committee noted its concern of any bank not being financially diversified by being able to lend more than 20% to one institution. The Committee also voiced concern that 20% of the bank's lending is in the millions of dollars while the FDIC insures only up to \$200,000. The Banking and Insurance Commissioner, at the September meeting, indicated that this is of no relevance to the proposed bill because the \$250,000 FDIC insurance is only a temporary one which will expire in December of 2009.

The Banking and Insurance Commissioner, at the September meeting also indicated that limitations on encumbrances is a requirement of the home supervisor. Foreign banks operating in the FSM do not need to disclose their capital if they already possess a permit.

Mr. Adams noted that the bank wishes to strike amendments to §612 since it treats investments in the same manner that it treats loans. This amendment would limit the size of the bank's investments because FDIC restrictions limit investments at \$250,000. The Bank of the FSM posits that investments in US securities are treated as loans by the amendments. Furthermore, these amendments do not effect foreign banks

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

and only effect the Bank of the FSM because it is the only "domestic bank."

Black's Legal Dictionary defines "loan" as, "1. An act of lending; a grant of something for temporary use. 2. A thing lent for the borrower's temporary use; esp., a sum of money lent at interest." Alternatively, Black's Legal Dictionary defines "invest" as, "1. To supply with authority or power. 2. To apply (money) for profit. 3. To make an outlay of money for profit." In a loan, you are borrowing money which is not yours which must be paid back. You must repay. In an investment, you are taking money that you have and setting it aside with the hopes of making more money. You may lose all of your money in an investment as there is no guarantee for repayment.

Mr. Joseph noted that the changes to §612 and §613 now title the sections "limitations on loans." Previously, these sections applied to loans and investments. Therefore, these amendments would effect investments although they are being titled related to "loans." Mr. Joseph also noted that the Bank of the FSM invests in various other instruments with other governments, for example Freddie Mac. Mr. Joseph stated that the most correct thing to do would be to have a section titled "loans and investments." The Banking and Insurance Commissioner, at the September meeting, stated that that the comments contained in the prior section are irrelevant because the references to "limitations on loans" in §612 and §613, although it was underlined in the proposed amendments, is not a change to the prior language.

The Banking and Insurance Commissioner, at the September meeting, stated that loans and investments are the same from a regulatory stance because there are liabilities with investments and loans. On the loan side, the principal must be repaid.

Mr. Adams noted that §612 (a) refers to investments such as brokered CDs which are secured by the FDIC. They are being considered as a loan under the amendments. By increasing the investment amount over 20%, the risk is increased. Mr. Adams noted that there are much higher standards when purchasing brokered CDs to ensure that a bank is "well capitalized." The proposed legislation would be a step towards reducing these standards.

Mr. De Courteney noted that the Bank of the FSM has been investing for twenty years with no restrictions. Now, the Bank of the FSM's investments are attempting to be limited. The Banking and Insurance Commissioner, at the September meeting, stated that that this statement is not true as there has always been the 20% requirement under the current law. Your Committee realizes that the misunderstandings created between the Bank of the FSMs interpretation and the Banking and Insurance Commissioner's interpretation results

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

from the amendments listing a type of investment in a section titled to deal with loans. Your Committee upon careful examination of Title 29 believes that any restrictions related to investments should mostly appropriately be placed under **§618 Prohibited investments by domestic banks** or under another relevant section specifically dealing with investments.

Approximately 50% of the Bank of the FSM's investments are with US agencies. With the new legislation (as interpreted by the Bank of the FSM as a limitation on loans and **investments**), the Bank of the FSM understands that they must reduce this number. Mr. De Courteney further stated that by having to sell down their loans that the Bank of the FSM may have to invest in more risky investments. Mr. De Courteney noted that the Bank of the FSM currently has \$5 million invested with Fannie May. If this amendment passes, that amount must be sold down. According to the Banking and Insurance Commissioner the Bank of the FSM's investments above the 20% with Freddy Mac and Fannie May have no guarantees from US banks.

The matrix provided to the Committee from by the Banking and Insurance Board state that the rationales/justifications for these changes are: Section a, "To exempt securities or investments entered into with the US governments and its agencies that are explicitly guaranteed by the US government;" Section b to give, "full faith [and] credit of the US government;" Section c, "[c]ash secured; no risk indebtedness;" New subsection, "[t]o allow flexibility to Banking Board to make judgments on counter parties' risk levels on a case-by-case basis."

Black's Legal Dictionary has several definitions for "security" including, "Collateral. . . . A security indicates an interest based on an **investment**. . . ." Your Committee understands loans and investments as two different types of instruments. Therefore, your Committee agrees that the reference to the specific investments (as seen in the mention of "securities") in the section related to loans is improper and confusing as a loan and an investment clearly are two separate things.

This could have been avoided through legal consultation. This leaves the members questioning what should be done with other types of investments not specifically mentioned in the amendment.

3. Increase the limitations on loans by related person for domestic banks from \$5,000 to \$25,000

Vice Chairman Otto questioned where we should draw the line regarding "relatives." Mr. Bacalando noted that §613 specifically defines "related persons." The Committee has observed clearly that reviewing §613 does not define "related persons." However, upon careful review

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

of Title 29 at 29 FSMC 102 (14) Related person was defined as, "spouse, child, parents, brothers, or sisters or any partnership, corporation, or firm which he owns more than a ten percent interest." The Banking and Insurance Commissioner, at the September meeting defined "related person" in a manner inconsistent to 29 FSMC 102(4) demonstrating that other relevant sections of the law related to these amendments were not reviewed, not explained or misunderstood

Vice Chairman Otto opinioned that the phrase "any related persons" be removed from §613. Vice Chairman Otto and the Chairman asked for clarification of how a person could be "indirectly" related to the bank.

Senator Halbert questioned banking policies where the banks lend only to their own employees. Those people not related to the bank are unable to secure loans. Senator Halbert questioned whether or not any language could be used to deter this behavior. Mr. Bacalando stated that the straight answer is "no."

Mr. Waguk noted that the \$5,000 lending limit under §613 is twenty years old. Currently, if bank staff needs a loan over \$5,000 they must go to the Board of Directors to sanction their loan. This serves as a disincentive to bank staff and their families to seek loans from their employers. It is quicker to obtain a loan at another bank. There is no limit on the amount of the loan at another bank.

The Banking and Insurance Commissioner, at the September meeting, stated that \$25,000 is a good limitation. This figure might even be considered low.

Under §613 Mr. Adams questioned why the "related persons" restriction applies only to domestic banks. Mr. De Courteney supported the increase in lending but requested that "related persons" be defined since it is difficult to determine with incorporated and unincorporated agencies, etc. He stated that all employee loans at the Bank of the FSM are submitted to the Board of Directors for approval.

The matrix provided to the Committee by the Banking and Insurance Board state that the rationale/justification for this change is, "[t]he original amount of \$5,000 was far below the levels at which boards normally get involved in credit decisions. The amount was introduced 20 years ago. The need to go through extra scrutiny is causing delays in loan processing."

The Board's remarks to this change are, "The original amount will continue to create additional level[s] of review or scrutiny on loans. The increased amount should eliminate that extra level and wait time."

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

Disko Jack, Operations Officer at the Bank of Guam stated that their employee loans are treated separately under bank policy so that loans are reviewed by a Committee.

The Committee requested that both banks submit their policy for dealing with and approving employee loans to the Committee in writing.

Mr. Finnen also noted that some of the amendments to these sections are repetitive since they are already in other sections of the law. Mr. De Courteney noted how important it is for all interested parties to work together when proposing amendments to the banking laws.

Your Committee has decided not to take action on C.B. NO. 16-05 except for those related to Section 613 at this time for the following three reasons:

1. The interested parties are not in agreement over the amendments,
2. The witnesses did not consult with legal counsel regarding the ramifications of these changes to the law and as demonstrated by investments being listed under a section dealing directly with loans and even by the witnesses confusion regarding the definition of "related persons" and
3. The amendments are repetitive and contain language that already exists in other sections of the law.

Your Committee, hereby, only approves changes under C.B. No. 16-05, C.D.1, Section 613 (2) to increase the amount of loans for related persons from \$5,000 to \$15,000.

Your Committee on Resources and Development is in accord with the intent and purpose of C.B. No. 16-05 and recommends its passage on First Reading, and that it be placed on the calendar for Second and Final reading in the form attached hereto as C.B. No. 16-05, C.D.1.

STANDING COMMITTEE REPORT NO: 16-50

RE: C.B. NO. 16-05

DECEMBER 05, 2009

Respectfully submitted,

/s/
Roger S. Mori, chairman

/s/
Tony Otto, vice chairman

/s/
Dohsis Halbert, member

/s/
Dion G. Neth, member

/s/
Peter Sitan, member

/s/
Joseph J. Urusemal, member

/s/
Paliknoa K. Welly, member