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This Policy Paper (PP) was dra□ed jointly by Republic of Marshall Islands O□ce of Banking Commission (OBC) and Gri□th Asia Institute's Pacific Islands Centre for Development Policy and Research (PICDPR). The PP was requested by OBC and will be presented to RMI Cabinet for implementation.

POLICY PAPER

December 2022

Introduction

This paper recommends the reconstitution of the Marshall Islands Office of the Banking Commission (OBC) as the Republic of the Marshall Islands Monetary Authority, with an expanded range of financial sector responsibilities.

The establishment of a Monetary Authority has been under discussion for the greater part of the last decade, and Cabinet previously approved such action within an appropriate legal framework, and alongside a wider Financial Sector Development Strategy (Cabinet Minute 188 (2015), dated 9 December 2015).

That Cabinet decision was prompted by: the difficulties RMI banks faced in maintaining international correspondent banking relationships (CBRs) in the face of stricter international standards on anti-money laundering (AML) and countering the financing of terrorism (CFT); the need to further develop the financial system to help counter major economic threats and to ensure financial stability in relation to public and Government deposits; the cessation of

Policy context

Current situation: RMI financial sector issues requiring a policy response

The core problem confronting the RMI Government is that RMI's continued access to the US banking system is not guaranteed despite the fact that the RMI is authorised under the existing Compact Agreement with the US to use the US dollar as its legal tender.

Without this access the RMI banking system will not be equipped to meet the financing needs of the RMI economy, which would have a major impact on employment, business investment, and long term economic development.

RMI has only two licensed and regulated commercial banks—the Bank of the Marshall Islands (BOMI), which is locally-owned, and the Bank of Guam (BoG), a branch of a US FDIC insured bank. BOMI has seen

a progressive reduction in its correspondent banking relationships—a trend being experienced by all small banks in Pacific Island countries (PICs) due to global de-risking.[1] Its only remaining CBR is with First Hawaiian Bank (FHB)—a former subsidiary of BNP Paribas.[2] FHB has wanted to end that relationship since 2014, and it has only retained the relationship until BOMI finds another CBR. Without that CBR, BOMI customers will not be able to undertake international transactions. BOMI has not been successful in finding another US bank CBR, primarily due to stringParibas.

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Pacific Islands experience

There are no like-for-like precedents among PICs. The Asian Development Bank recognises 14 Pacific developing member countries—PICs in this paper. Six have central banks—Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu—but these countries issue their own currencies. The three North Pacific countries—Federated States of Micronesia,

Palau, and RMI use the US dollar and have a banking
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regulator; Kiribati, Nauru, and Tuvalu use the Australian
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General features of monetary authorities

Monetary authorities are a common feature of the international financial landscape, including in some PICs. These authorities typically have responsibility for currency issuance (whether that be a domestic or regional currency), government banking services, inter-bank payments and clearing, monetary

policy directed towards price stability, government cash and debt management, and foreign reserves management. Other responsibilities vary, o en as a function of population size and the level of financial sector development. These other responsibilities may include banking licensing, regulation and supervision, and sometimes wider financial sector regulation

and supervision, financial sector development policy, financial inclusion, and oversight of any unit responsible for implementing and complying with

international AML/CFT standards. (The responsibilities recommended for the RMI Monetary Authority are elaborated in the next section).

The pressing practical policy consideration is whether a monetary authority is a suitable institutional arrangement for RMI, a small country with a largely underdeveloped financial system and where there is no national currency—the US dollar being the sole o cial currency, pursuant to Section 251 of the 2003 Compact Agreement.

The consistent financial and technical support from donors and the government has given the institution the space and resources to pursue capacity building at a steady pace. At the same time, senior and middle management have strongly supported the institutional development roadmap and kept a consistent focus on reaching milestones and, ultimately the goal of becoming a fully independent central bank. Early successes have contributed to creating a strong organisational identity and culture, including demonstrating the importance and benefits of transparency and reaching out to stakeholders.[4]

The BCTL experience provides a useful blueprint for the establishment and growth of the RMI Monetary Authority.

Building an effective RMI Monetary Authority

Banking, clearing and currency services

As a bank, the RMI Monetary Authority will provide correspondent banking, clearing, and settlement arrangements for the RMI Government. It would act as the Government's fiscal agent, providing deposits and payment services for the Government's operating expenditures. It could also provide a similar service to the Social Security Administration System.

The Monetary Authority could extend loans to banks and other financial sector participants to, for example, support individual bank/system liquidity or solvency, as many monetary authorities did in response to COVID-19 and the Global Financial Crisis. It is also possible that the Monetary Authority could play a role in selected policy lending—to further financial inclusion, for example, or to underpin economic activity—but the merits of this type of lending would require a rigorous policy assessment and would have to be rationalised with the mandate and activities of the Marshall Islands Development Bank.

Unlike most monetary authorities, a RMI Monetary Authority would not issue currency—issuance of US currency being a responsibility of the Federal Reserve System. However, it could be provided the flexibility under its legislation to issue a national currency of the RMI and undertake monetary policy if needed. The RMI Monetary Authority would be responsible for ensuring that there is an adequate stock of US dollars in circulation to meet the demand for currency. This could mean that the Monetary Authority might have to play a warehousing role to ensure that banks could meet customer demand for currency. In Timor-Leste, BCTL does issue local currency coins—centavos—where 1 centavo is equivalent to US 1 cent. RMI is unlikely to follow this precedent, but it is conceivable that RMI could issue a sovereign central bank digital currency that is equivalent to the US dollar, but which carried a name that identified it as a RMI sovereign currency. The RMI Monetary Authority would be responsible for formulating and implementing any policy on the issuance and use of a sovereign central bank digital currency.

Government funds management

Given that the Monetary Authority is the Government's fiscal agent, it can play a wider role in government funds management—a treasury function. As a treasury, the Monetary Authority would manage: (i) Government cash flows to avoid holding unnecessary working balances and to earn interest on other balances; (ii) Government debt, being responsible for preparing a debt management strategy, issuing debt, and managing the maturity and risk profile of this debt; and (iii) other financial assets, including investments held outside RMI.

Financial sector stability

The Monetary Authority's responsibility for financial sector stability would encompass financial sector regulation and supervision, lender of last resort facility, and deposit insurance.

While OBC's primary focus has been on the banking system, its mandate extends to non-banks—licensing of designated non-financial businesses and professions or non-financial services providers (DNFBPs) and to the AML/CFT obligations of banks and DNFBPs. This mandate needs to be broadened to include financing other than credit, such as capital raising. Capital raising is critical to longer-term economic development and businesses should not be forced to rely on bank or non-bank credit. Capital raising is not limited to initial public offerings that are listed on a stock exchange. Smaller businesses also need capital to finance their growth, typically equity shares or long-term debt instruments, but a legal framework is needed. This can be provided through corporations' law or law specific to small-scale capital raising. Innovations in small-scale capital raising, such as equity crowd funding and peer-to-peer lending, are well-suited to financing small businesses and would be captured under this expanded regulatory framework. As is the case for banking regulation,

the broad objective is to develop and implement a regulatory framework that finds an appropriate balance between incentivizing the issuance of securities and protecting those that invest in those securities. The framework would cover licensing, regulation, and supervision.

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Financial sector development and policy

The broad policy brief for the new RMI Monetary Authority should be to design a financial sector architecture that will meet the financing needs of RMI businesses and households. Describing a financial sector architecture is, in essence, an exercise in mapping risks to be financed against the type of financial institution needed to finance that risk. If the financial system comprises institutions that are only prepared to finance low-risk activities, then economic development will be compromised as the risk finance needed to underpin economic development will not be provided. Insurance and capital raising are important components of the risk spectrum.

In addition to the need for more emphasis on long-term investment finance discussed earlier, financing climate change adaptation is a critical policy issue for RMI (as it is for other PICs), and the Monetary Authority has a key role to play in developing the policies that are needed. A Monetary Authority with banking capability and international correspondent relationships can be expected to open up sources of climate change financing, such as that provided by the Green Climate Fund (GCF), which channels financing through accredited national institutions. Accredited entities develop funding proposals for consideration by the Fund and oversee, supervise, manage, and monitor their respective GCF-approved projects and programs. The threshold set by GCF for achieving accreditation is high: very few PIC banks have met the standard, and it is unlikely to be met by existing RMI banks. Monetary authorities in small countries often become the lead agency for furthering financial inclusion on behalf of government, developing policies and strategies to achieve this end. That is the norm in PICs with central banks and for Timor-Leste.

The financial development plan is the key instrument for structuring policy on financial sector development, and any plan needs to be periodically reviewed and updated. Financial inclusion could be a component of the master plan, or it could be addressed in a separate exercise.

Economic and other research

Central banks typically have an in-house economic research department, as overall economic structure and performance is inextricably linked to financial sector policy. The RMI Monetary Authority should also have this capability, aiming to have a small research team that can contribute to both economic and financial sector research, including financial inclusion. It is not efficient to have this research capability spread across several organisations in small countries.

Specialist finance-related government administrative units

It is not uncommon for the Financial Intelligence Unit (FIU) of a small country to be housed within its Monetary Authority, where that authority exists. The head of the authority is empowered to oversee the operations of the FIU, but the level of operational autonomy and extent of its integration with the wider activities of the authority can vary. The RMI FIU is integrated into the existing OBC structure, and that arrangement can be transferred to a new RMI Monetary Authority.

Funding and capital

OBC is currently funded through annual appropriations from the government budget. In contrast, a new Monetary Authority would provide banking services and would need to operate as a financial institution off its own balance sheet.

There are two key policy considerations. First, the Monetary Authority needs to be able to meet any financial liabilities arising from its own banking activities—for example, government deposits and settlement balances held by banks—and from providing support to the financial system—for example, repurchasing government securities for monetary management purposes; and second, the operating expenditures of the Monetary Authority need to be financed in a way that encourages the efficient use of resources. A mixed funding model could be employed—a mix of budget allocation purpoplcial Tn-t

The general approach is to ensure that any monetary authority has sufficient financial strength, where "financial strength refers to the ongoing ability of the central bank to fund and implement operations in line with the policy aims for which it is independently responsible".[5] The initial capital of the Monetary Authority could be allocated capital (for example, through an allocation of government securities or a transferring ownership of foreign reserves held by the government to the Monetary Authority) sufficient to fund operating expenditure and provide a buffer to cover future contingencies.

Capital requirements are also influenced by any legislative provisions covering retained earnings and dividend payments to government, and by recapitalisation arrangements, whenever this becomes necessary. The Monetary Authority either needs to maintain a capital buffer to protect against losses, or there could be a standing commitment from the government to recapitalise when needed (for example, if the Monetary Authority suffered losses as a result

of providing financial support to the banking system). The choice of approach turns on what arrangement is seen as the more credible in the eyes of market participants and international counterparties.[6] For RMI, a standing commitment to capitalise and recapitalise the RMI Monetary Authority, when necessary, could be incorporated into the renegotiated Compact agreement, and this would likely enhance perceptions of the RMI Monetary Authority's credibility.

Governance and Autonomy

Institutional strengthening

Given its responsibilities and economic impact, the RMI Monetary Authority will need to have a highly competent technical staff, as well as being a well-managed and well-governed organisation. Human resources policies will have to be aligned to these objectives, especially policies on remuneration and staff development. Staff remuneration will need to be delinked from prevailing Public Service Commission remuneration arrangements, and staff will need to continue to develop technical capacities to address emerging policy challenges and respond to financial sector innovation.

The World Bank's case study on BCTL highlighted the importance of "sustained emphasis on improving the capacity of national staff and organisational learning, and ... consistent financial and technical support from donors and the government" in allowing BCTL "to pursue capacity building at a steady pace".[7] RMI is well-placed to emulate BCTL's experience, given its strong existing multilateral—IMF, World Bank, ADB— and bilateral—particularly the US—relationships.

These relationships have provided access to training and technical assistance. The IMF has already offered to provide technical assistance to RMI to establish a monetary authority and introduce a sovereign central bank digital currency, and OBC is a member of the Association of Financial Supervisors of Pacific Countries, for which IMF provides the Secretariat through its Pacific Financial Technical Assistance Center (PFTAC). OBC has recently signed a research support agreement with Griffith University in Australia, through its Pacific Islands Centre for Development Policy and Research (formerly the South Pacific Centre for Central Banking). It is also conceivable that the South Pacific Central Bank Governors' forum would expand

Notes

1. Global financial institutions threatening to cut off access to global financial system for local banks and remittance companies in certain regions, putting them at risk to the global financial system;
2. FHB recently bought back its shares from PNB Paribas;
3. Both the Banking & Payments Authority and the Central Payments Office were set up by United Nations Transitional Administration of East Timor, prior to Timor-Leste gaining independence in 2002.
4. Lorena Viñuela, 'Timor-Leste Case Study: The Central Bank of Timor-Leste', in Institutions Taking Root: Building

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