

***FEDERATED STATES OF
MICRONESIA
DEVELOPMENT BANK***



Annual
Report

2010

"YOUR PARTNER IN BUSINESS"

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(3) Loans Receivable

The following is a schedule of loans receivable as of December 31, 2010:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net</u>
PDLF and YDF	\$ 76,549	\$ -	\$ 76,549
IDF	<u>6,694,733</u>	<u>19,500</u>	<u>6,675,233</u>
	<u>\$ 6,771,282</u>	<u>\$ 19,500</u>	<u>\$ 6,751,782</u>

Management is of the opinion that since these are trust funds, they are usually unable to provide against these balances, and therefore these loans have been presented as restricted net assets.

(4) Return of Net Assets

During the year ended December 31, 2010, net assets were returned to the following:

Kosrae State	\$ 255,982
Pohnpei State	<u>1,357,492</u>
	<u>\$ 1,613,474</u>

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Dear Shareholders:

On behalf of the Board of Directors, we are pleased to submit FSMDB's (bank) 2010 annual report.

2010 was not a very productive year for the Bank as there were no major new developments in the private sector. The construction and mining sector encountered financial problems, suffering losses from nationally funded infrastructure projects. Total assets for the Bank increased due to an increase in lending funded by outside sources. There is a corresponding increase in liabilities as the Bank continues to borrow funds to finance its lending activities. In addition to the residential home loan program the Bank approved \$11 million for only 39 projects compared to last year's approval of \$10.7 million for 61 projects. The Bank anticipates further growth in the loan portfolio in 2011 for the real estate, construction and tourism sectors. The Bank was able to generate \$2.2 million in loan interest income for 2010 and was able to cover its operating expenses in full. The Bank also recovered some of its losses in its investment portfolio by earning \$0.8 million in its investment portfolio in the U.S. capital market. The Bank ended the year with a total increase in net assets of about \$1.65 million. About \$9.6 million of approved loans were undisbursed at year end.

Summary Statement of Net Assets

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Assets:			
Current assets	\$ 13,361,733	\$ 13,622,277	\$ 7,337,839
Noncurrent assets	<u>26,672,972</u>	<u>24,828,784</u>	<u>28,900,915</u>
Total assets	\$ <u>40,034,705</u>	\$ <u>38,451,061</u>	\$ <u>36,238,754</u>
Liabilities:			
Liabilities	\$ <u>1,757,851</u>	\$ <u>1,827,199</u>	\$ <u>2,207,214</u>
Net assets:			
Invested in fixed assets	229,453	224,450	226,565
Unrestricted	<u>38,047,401</u>	<u>36,399,412</u>	<u>33,804,975</u>
Total net assets	<u>38,276,854</u>	<u>36,623,862</u>	<u>34,031,540</u>
Total liabilities and net assets	\$ <u>40,034,705</u>	\$ <u>38,451,061</u>	\$ <u>36,238,754</u>

During fiscal year 2010, the Bank started drawing down funds borrowed from USDA RECD Intermediary Relending Program to facilitate lending to small and medium enterprises in the FSM. At year end, the outstanding balance of this loan was \$116,564. Repayment of the \$2 million borrowed from the Export and Import Bank of China continued in 2010 and the outstanding balance at year end was \$1,200,000. During 2010 the Bank signed a Finance Contract for a loan in the amount of EUR 4 million with the European Investment Bank. At year end, the Bank has not drawn from this loan. For additional information concerning the Bank's debt, please refer to note 8 to the financial statements.

B. Investments

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

- Category 1 Investments that are insured or registered, or securities held by the Funds or its agent in the Funds' name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Funds' name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Funds' name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of December 31, 2010, investments at fair value are as follows:

Other investments:
 Money market funds \$ 867,838

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. As of December 31, 2010, the Funds did not have any credit risk debt securities.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Funds will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Funds' investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Funds' name by the Funds' custodial financial institutions at December 31, 2010.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Funds do not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

- (iv) Insurance company obligations - Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in the Federated States of Micronesia or in any state, territory or commonwealth of the United States provided that the total market value of these investments at no time shall exceed ten percent of all investments.

A. Deposits

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by the Funds or its agent in the Funds' name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Funds' name; or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Funds' name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Funds' deposits may not be returned to them. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Funds do not have a deposit policy for custodial credit risk.

As of December 31, 2010, the carrying amount of the Funds' total cash and time certificates of deposit was \$2,395,984 and the corresponding bank balances approximated the same amount. All of the bank balances are maintained in interest-bearing transaction accounts in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2010, bank deposits in interest-bearing transaction accounts in the amount of \$500,000 were FDIC insured. The Funds do not require collateralization of their cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. Management's confidence in the financial strength of their banking institutions was the basis of the decision to not require collateralization. No losses as a result of this practice were incurred for the year ended December 31, 2010.

Earnings in 2010 were positive at \$1,652,992 but less than last year's earnings of \$2,592,322, due to the substantial amount of loans that were undisbursed during the year. The original 2010 provision for loan losses was reversed and added back to revenue as there was a sufficient loan loss reserve to cover potential losses, plus there were no loans charged off in 2010. At the end of 2010, the total loan loss provision to total impaired assets was at 99%.

Summary Statement of Revenues, Expenses and Changes in Net Assets

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Operating revenues	\$ 2,444,276	\$ 2,500,007	\$ 2,333,226
Recovery of (provision for) doubtful loans	103,860	365,582	(722,000)
Operating expenses	<u>(1,948,595)</u>	<u>(1,824,264)</u>	<u>(1,677,657)</u>
Earnings (loss) from operations	599,541	1,041,325	(66,431)
Non-operating revenues (expenses), net	<u>1,053,451</u>	<u>1,550,997</u>	<u>(1,591,362)</u>
Change in net assets	1,652,992	2,592,322	(1,657,793)
Net assets at beginning of year	<u>36,623,862</u>	<u>34,031,540</u>	<u>35,689,333</u>
Net assets at end of year	\$ <u>38,276,854</u>	\$ <u>36,623,862</u>	\$ <u>34,031,540</u>

We anticipate lending to improve in 2011 as the private sector expands as a result of improved infrastructure in the FSM. Improvements in the foreign investment environment particularly in Pohnpei could contribute to an increase in foreign and local partnerships in the tourism industry. The Bank foresees an increase in business activities relating to infrastructure development that is stimulating the economy, not only in the construction businesses but the other support service sectors. We anticipate improvement in the tourism industry beyond 2011, particularly in Pohnpei after the new extended airport runway in Pohnpei is completed. In addition, the creation of resident offices of International and Regional Organizations in Pohnpei is also increasing the need for new real estate development, both for office space as well as rental units for housing. The Bank sees an increase in lending in the real estate development sector in 2011 and onward.

In closing, we wish to acknowledge and extend our sincere gratitude and appreciation for your continued support and confidence in the FSMDB. We further extend the same to our esteem colleagues, the members of the Board of Directors, for their unwavering commitments and valuable insights that they have contributed throughout the years toward the advancement of this institution. We wish to also thank our employees for their hard work and their firm commitments to put our words into actions. And finally, we thank our customers for their continued loyalty and confidence in the FSMDB. We thank you for giving us the opportunity to serve you. It is our hope that you will continue to allow us to serve you while extending opportunities to other aspiring entrepreneurs. As always, we shall remain **"Your Partner in Business"**.

Sincerely,



Anna Mendiola, President/CEO



Ihlen Joseph, Chairman - Board of Director

Part 1: Background Information

ABOUT THE BANK

The Federated States of Micronesia Development Bank (FSMDB) is a subcomponent unit of the National Government of the Federated States of Micronesia (FSM). It was established in 1979 by the First Congress of the Federated States of Micronesia. The bank opened in 1980 but lending did not start until 1982. In 1994, the enabling law that created the bank was amended to reorganize the structure of the bank to reflect that of a normal corporation. The bank, however, maintained its subcomponent status.

While providing financing to viable commercial oriented endeavors within the Federated States of Micronesia remains its primary function, the FSMDB is now a full fledged Residential Home lender since 2008.

With four branch offices in all FSM States, the bank's head-quarters is located in Pohnpei, the capital of the FSM. The United States Dollar (USD) is the official currency of the FSM. The financial reports and transactions presented in this report are in \$USD.

VISION AND MISSION

Vision:

The FSM DEVELOPMENT BANK is a key player in the development of the private sector in the Federated States of Micronesia that enjoys the confidence of the national and state leaders, its customers, regulators and stakeholders.

FSMDB services and performance are comparable to the best-managed development financial institutions in the Pacific region.

Mission:

- *FSM Development Bank actively promotes the growth of micro, small and medium enterprises in the Federated States of Micronesia and supports programs designed to help business achieve greater efficiency in their operations.*
- *The policies of the FSMDB are constantly aligned with the overall socio-economic goals of the nation and it continues to coordinate closely with the governments and community leaders in defining its strategic directions.*

Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of the Funds are governed by their enabling legislation. The Bank is required to engage one or more fund custodians to assume responsibility for the physical possession of the Funds' investments. Legally authorized investments are as follows:

- (i) Government obligations - Obligations issued or guaranteed as to principal and interest by the National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.
- (ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or other mortgage-backed securities provided that the obligation is an agency of the United States Government, the National Government of the Federated States of Micronesia, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the Funds' investments or ten percent of the outstanding value of the issue at the time of purchase.
- (iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Funds' investment advisor at the time of purchase, that not more than five percent of the market value of its investments shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of its investments shall be invested in any one industry group.

Notes to Financial Statement Administered Funds

(1) Purpose and Summary of Significant Accounting Policies

Purpose

The Investment Development Fund (IDF), the Pohnpei Development Loan Fund (PDLF), and the Yap Development Loan Fund (YDLF), are administered by the Federated States of Micronesia Development Bank (the Bank). The Bank utilizes the Funds to carry out its stated purpose of providing loans for the economic development of the FSM. The specific purpose of each fund is as follows:

IDF was created to finance projects which will (1) have their operations primarily located within the FSM; (2) improve the balance of payments position of the FSM; (3) increase the value of visible and invisible exports or result in import substitutions; (4) demonstrate positive economic returns; (5) contribute to the furtherance of close economic relations with the USA. The IDF is administered by the Bank in a Trust capacity on behalf of the FSM National Government and its four States.

PDLF and YDLF are administered by the Bank in a Trust capacity. All loan decisions are made by executives of the respective state governments as these funds represent local appropriations designated to be loaned for development purposes.

Fund Structure and Basis of Accounting

The accounts of the IDF, PDLF and YDLF are accounted for as fiduciary fund types as the amounts are to be reported on the respective entities' financial statements (the FSM National Government, Pohnpei State and Yap State, respectively).

Cash

For the purposes of the statement of fiduciary net assets, cash is defined as cash in bank checking and savings accounts, and commercial paper with original maturities of three months or less from the date of acquisition. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified.

Investments

Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale and is primarily determined based on quoted market values.

Loans and Allowance for Loan Losses

Loans under the trust funds are usually reported at gross unpaid principal balances, without an allowance for loan losses. The loans are reserved in net assets as restricted net assets. Loans are written off directly against income based on discussions with the owners of the managed funds. When the loans are recorded in the respective owner's financial statements, the owners of these funds will bear responsibility for establishing the related loan loss reserve.

- *FSMDB processes are designed to deliver efficient and timely services to its customers, and ensure effective exchange of information at all levels of the organization.*
- *The FSMDB organization is characterized by a high level of teamwork and morale. FSMDB supports its people with appropriate equipment and technology, ensures that its compensation and reward program are competitive within the industry, and implements a conscious program for the continuous professional growth and personal development of its people.*
- *FSMDB maintain a consistently healthy and growing financial portfolio and continues to earn the respect and support of the general public, the various governments, donor agencies and the international financial community*

SHAREHOLDERS

The FSM National Government is the principal shareholder of the bank. It owns 98.7% of the outstanding shares. The States of Chuuk and Kosrae each own 1.0% and 0.3% of the bank's outstanding shares respectively. The States of Pohnpei and Yap are not shareholders but they are given representation on the Bank's Board of Directors as a courtesy.

Shareholder	No. of Shares	Amount
FSM National Government	2,997,883	\$14,989,415
State of Kosrae	9,000	\$45,000
State of Chuuk	30,000	\$150,000
Total Shares Outstanding	3,036,883	\$15,184,415

The Bank's fiscal year runs on a calendar year basis. The shareholder meets annually normally during the second Quarter of the Bank's fiscal year.

Trust Funds
Statement of Fiduciary Net Assets
December 31, 2010

	IDF	PDLF	YDLF	Total
<u>ASSETS</u>				
Held by FSMDB:				
Cash in bank and on hand	\$ -	\$ 208,852	\$ 52,439	\$ 261,291
Time certificates of deposit	1,420,551	569,812	144,330	2,134,693
Held by trustee:				
Investments	867,838	-	-	867,838
Total cash and equivalents	<u>2,288,389</u>	<u>778,664</u>	<u>196,769</u>	<u>3,263,822</u>
Receivable from FSMDB	161,108	-	27,266	188,374
Interest and other receivables	3,418	1,326	71	4,815
Loans receivable, net	6,675,233	37,770	38,779	6,751,782
Total receivables	<u>6,839,759</u>	<u>39,096</u>	<u>66,116</u>	<u>6,944,971</u>
	<u>\$ 9,128,148</u>	<u>\$ 817,760</u>	<u>\$ 262,885</u>	<u>\$ 10,208,793</u>
<u>LIABILITIES AND NET ASSETS</u>				
Liabilities:				
Payable to FSMDB	\$ 291,887	\$ 93,114	\$ 15,623	\$ 400,624
Commitments				
Net assets:				
Restricted	6,675,233	37,770	38,779	6,751,782
Unrestricted	2,161,028	686,876	208,483	3,056,387
Total net assets	<u>8,836,261</u>	<u>724,646</u>	<u>247,262</u>	<u>9,808,169</u>
	<u>\$ 9,128,148</u>	<u>\$ 817,760</u>	<u>\$ 262,885</u>	<u>\$ 10,208,793</u>

See accompanying notes to financial statements.

BOARD OF DIRECTORS

Because of the need to operate the bank in a commercial manner, a Board of Directors was created to supervise the bank. The board is comprised of seven members. Six of them are elected by the shareholders. The seventh member is the President and Chief Executive Officer (CEO), who serves as the Ex-Officio to the board. Aside from the Ex-Officio, all board members serve a term of 3 years on a staggering basis. And despite the ownership make-up, all of the board members have equal voting rights. Regular board meetings are held four times a year on a calendar quarterly basis. Special meetings can be held at the board's discretion.

Being the principal shareholder, the FSM National Government is represented with two seats on the board. Each of the FSM states is given a seat on the board. The composition and representation of the board as of December 31, 2010 were as follows:

Name	Position	Representation
Ihlen Joseph	Chairman	FSM National Government
Hilary Tacheliol	Vice Chairman	Yap State
John Sohl	Member	Pohnpei State
Wilson Waguk	Member	Kosrae State
Sisinio Welly	Member	Chuuk State
Juliet Jimmy	Member	FSM National Government
Anna Mendiola	Ex-Officio	President/CEO FSMDB

MANAGEMENT

The bank is managed by a management team comprised of a President and Chief Executive Officer, a Senior Vice President, a Chief Financial Officer and a Senior Lending Officer

The Senior Management of the Bank as of December 31, 2010 was as follows:

Name	Position	E-mail
Anna Mendiola	President/CEO	annam@fsmdb.fm
Stevenson Joseph	Senior Vice President	stevej@fsmdb.fm
Sihna Lawrence	Chief Financial Officer	sihnal@fsmdb.fm
Peter Aldis	Senior Loan Officer	petera@fsmdb.fm

Part 2: Management Report

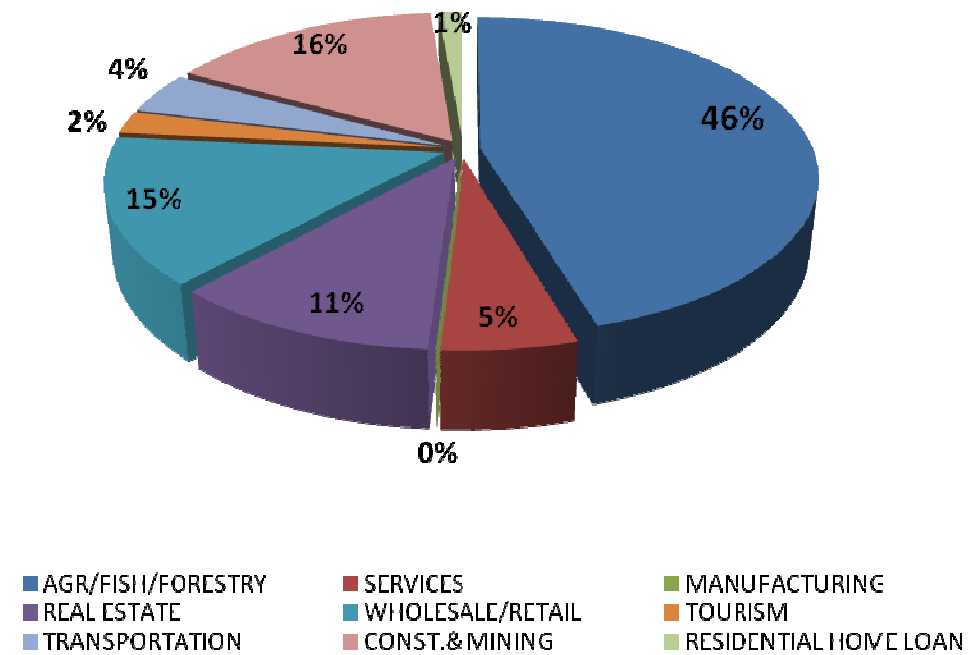
I. Lending Activity

We approved 39 loans in 2010 with the total value just under \$11 million. Compared to the previous year (2009), the value increased but the number of loans decreased \$200 thousand from \$10.7 million but declined by 22 loans from 61 in terms of the number.

Table 1: Loans Approved in 2010

Sector	Number	Value
AGR/FISH/FORESTRY	3	\$ 5,004,092
SERVICES	2	600,000
MANUFACTURING	1	1,000
REAL ESTATE	7	1,188,973
WHOLESALE/RETAIL	13	1,627,945
TOURISM	1	250,000
TRANSPORTATION	4	472,711
CONST.& MINING	5	1,708,775
RESIDENTIAL	3	144,247
	39	\$ 10,997,743

Figure 1: Loans Approved by Sector



(10) Retirement Plan

The Bank's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees receive from the FSM Social Security System. The Plan is a contributory plan in which the Bank matches 100% of the participants' contributions up to a maximum of 10 percent of the participant's annual salary, if the participant contributes 3 or more percent from his or her annual salary. Employee participation is optional. The Bank's Chief Financial Officer is the designated Plan Administrator. Matching contributions to the Plan during the years ended December 31, 2010, 2009, and 2008 were \$56,824, \$51,395, and \$54,035, respectively. Management is of the opinion that the Plan does not represent an asset or a liability of the Bank.

(11) Staff Loan Revolving Fund

In July 2007, the Bank's Board of Directors approved the establishment of a Staff Loan Revolving Fund. In September 2007, a savings account was established for this purpose. As of December 31, 2010 and 2009, the account has a balance of \$81,574 and \$81,428, respectively.

On December 8, 2009, the Bank was awarded an Intermediary Relending Program (IRP) loan by the U.S. Department of Agriculture in the amount of \$466,254. The loan requires interest only payments for the first three years; thereafter, principal and interest is payable in equal annual installments beginning on December 8, 2013. The loan matures on December 8, 2039. The loan bears a fixed interest rate of one percent per annum. At December 31, 2010 and 2009, outstanding balances were \$116,564 and \$0, respectively. The loan is assumed to be fully disbursed by December 8, 2012, which is the last annual interest-only payment period.

On August 30, 2010, the Bank entered into a line of credit agreement in the amount of EUR 4,000,000 with European Investment Bank for a term of fifteen years. The loan is uncollateralized and bears interest at the London Interbank Offered Rate on the date of drawdown plus a 1.76% risk premium per annum. No drawdowns have occurred as of December 31, 2010.

Annual debt service requirements to maturity for principal and interest are as follows:

Year ending December 31,	Principal	Interest	Total
2011	\$ 400,000	\$ 82,346	\$ 482,346
2012	400,000	52,826	452,826
2013	415,128	23,154	438,282
2014	15,279	1,013	16,292
2015	15,432	1,011	16,443
2016-2020	<u>70,725</u>	<u>2,292</u>	<u>70,017</u>
	<u>\$ 1,316,564</u>	<u>\$ 162,642</u>	<u>\$ 1,479,206</u>

Long-term debt changes during the years ended December 31, 2010 and 2009 are as follows:

	Balance January 1,	Additions	Reductions	Balance December 31,	Due Within One Year
2010: Loan payable	\$ <u>1,600,000</u>	\$ <u>116,564</u>	\$ <u>(400,000)</u>	\$ <u>1,316,564</u>	\$ <u>400,000</u>
	Balance January 1,	Additions	Reductions	Balance December 31,	Due Within One Year
2009: Loan payable	\$ <u>2,000,000</u>	\$ <u>-</u>	\$ <u>(400,000)</u>	\$ <u>1,600,000</u>	\$ <u>400,000</u>

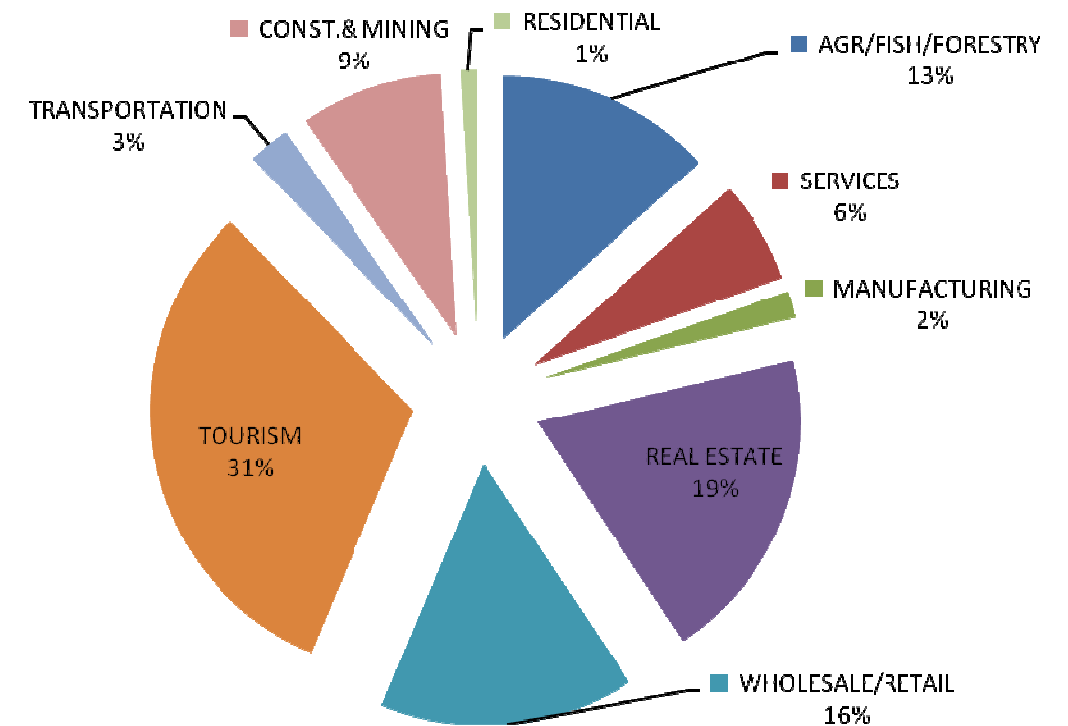
(9) Contribution from the FSM National Government

The Bank was reimbursed for expenses incurred in administering the IDF program from the IDF Private Sub Account for \$250,000 for each of the years ended December 31, 2010 and 2009.

Table 2: Active Loans Outstanding (gross) as of December 31, 2010 (Direct Portfolio)

Sector	Number	Value
AGR/FISH/FORESTRY	17	\$ 3,587,041
SERVICES	40	1,696,517
MANUFACTURING	17	441,098
REAL ESTATE	34	5,247,317
WHOLESALE/RETAIL	71	4,227,025
TOURISM	15	8,484,951
TRANSPORTATION	9	680,801
CONST.& MINING	14	2,354,962
RESIDENTIAL	7	257,981
	224	\$ 26,977,693

Figure 2: Outstanding Loans by Sector as of December 31, 2010



At the end of 2010, a large portion or 63% of our loan portfolio was predominantly in the following sectors: Tourism (31%), Real Estate (19%), Wholesale/Retail (16%) and Agriculture/Fisheries/Forestry (13%). In terms of the number of loan, however, Wholesale/Retail has the most loans outstanding with a total of 71 loans followed by Services (40) and Real Estate (34).

Figure 3: Loan Approval Trend 2006-2010

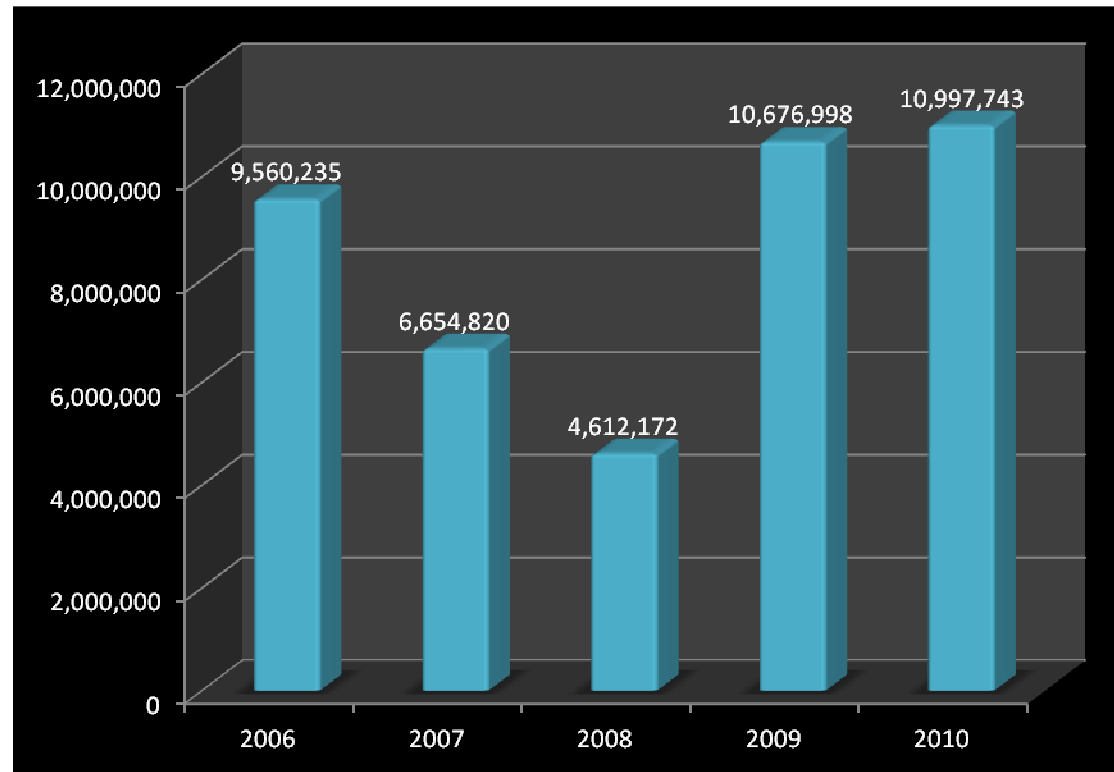
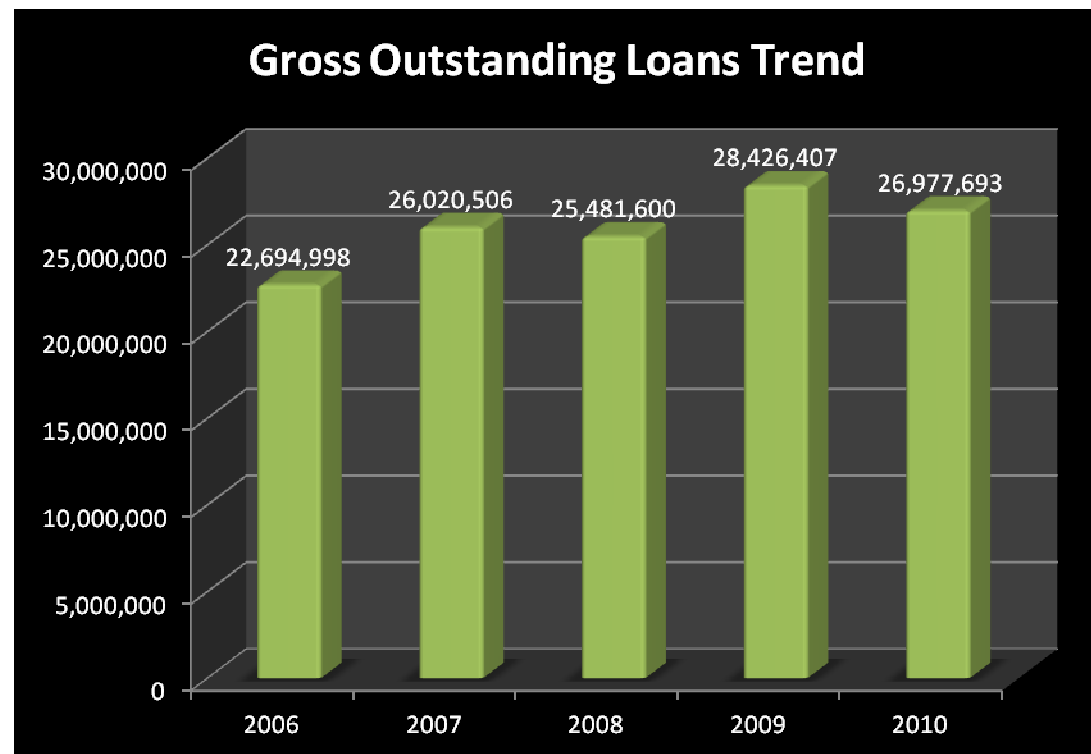


Figure 4: Gross Loan Outstanding Trend 2006-2010



Litigation

The Bank is a party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

Self Insurance

The Bank carries insurance to cover its potential risks from vehicle usage. The Bank is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice during the past three years.

Lease Commitments

The Bank has seven operating leases as of December 31, 2010. Three are residential real estate leases for contract employees. Four leases are for the branch offices in each State (one with a lease term of two years, two for five years and one for fifteen years). Except for one residential real estate lease, all other leases have an attached option allowing the Bank to renew the lease upon expiration of the current term. It is likely that these options will be exercised by the Bank and the leases renewed. The approximate future minimum annual lease payments payable by the Bank, assuming all options are exercised, are as follows:

<u>Year ending December 31,</u>	<u>Total</u>
2011	\$ 133,120
2012	124,320
2013	124,320
2014	124,320
2015	124,320
2016 – 2020	621,600
2021 – 2025	621,600
2026 – 2030	621,600
2031 – 2035	621,600
	<u>\$ 3,116,800</u>

(8) Long-Term Debt

On September 29, 2007, the Bank entered into a line of credit agreement with Export and Import Bank of China in the amount of \$2,000,000, due July 21, 2013, for the purpose of funding its loan programs. The loan is uncollateralized, bears interest fixed at 7.38% per annum. Repayment of principal and interest commenced on January 21, 2009 in semi-annual principal installments of \$200,000. As of December 31, 2010 and 2009, the amount outstanding and payable was \$1,200,000 and \$1,600,000, respectively.

(5) Fixed Assets

A summary of fixed assets as of December 31, 2010 and 2009, is as follows:

	Beginning Balance January 1, 2010		Additions	Deletions	Ending Balance December 31, 2010
Office furniture, fixtures and equipment	\$ 154,579	\$ -	\$ -	\$ -	\$ 154,579
Home furniture, fixtures and equipment	14,098	-	-	-	14,098
Vehicles	231,129	53,269	-	-	284,398
Computers and software	596,631	46,659	-	-	643,290
	996,437	99,928	-	-	1,096,365
Less accumulated depreciation	(771,987)	(94,925)	-	-	(866,912)
Net fixed assets	\$ 224,450	\$ 5,003	\$ -	\$ -	\$ 229,453

	Beginning Balance January 1, 2009		Additions	Deletions	Ending Balance December 31, 2009
Office furniture, fixtures and equipment	\$ 144,996	\$ 9,583	\$ -	\$ -	\$ 154,579
Home furniture, fixtures and equipment	14,098	-	-	-	14,098
Vehicles	231,129	-	-	-	231,129
Computers and software	527,364	69,267	-	-	596,631
	917,587	78,850	-	-	996,437
Less accumulated depreciation	(691,024)	(80,963)	-	-	(771,987)
Net fixed assets	\$ 226,563	\$ (2,113)	\$ -	\$ -	\$ 224,450

(6) Related Party Transactions

As of December 31, 2010 and 2009, the Bank has direct loans with outstanding balances of \$195,881 and \$186,647, respectively, to employees of the Bank and project loans extended to businesses owned by or affiliated with employees of \$2,446,679 and \$2,424,869, respectively. These loans were made under similar terms and conditions as exist with other borrowers. Officers and Board members are not eligible to borrow from the Bank.

(7) Commitments and Contingencies

Guaranty

The Bank, from time-to-time, is contingently liable on loan guarantees ranging from 50% to 90% of the outstanding loan balances for commercial projects within the FSM. There were no outstanding guaranteed loan balances as of December 31, 2010 and 2009.

Loan Commitments

The Bank has entered into loan commitments for loans approved but undisbursed in the amount of \$9,563,505 at December 31, 2010.

II. Funding Source Update

Capital contribution from our principal shareholder, the FSM National Government, has not been forthcoming for the last five years of operations as it used to be in the earlier years of the bank's existence. We now rely on other sources to fund our lending activities. As of this reporting we have secured and have on lent the following sources:

- A \$2 million loan from the China Export and Import Bank. 27 projects were funded under this fund source.
- A \$462k loan from Intermediary Relending Program with the U.S. Department of Agriculture Rural Development Office.
- We have been offered a \$5 million credit line from the European Investment Bank (EIB). We anticipate to close this loan early 2011.

III. Administered Funds Update

We manage three non-proprietor type funds: 1) the Investment Development Fund (IDF), 2) the Pohnpei Development Loan Fund (PDLF) and 3) the Yap Development Loan Fund (YDLF). The detail and the current status of these funds can be found in the financial section of the report.

IV. Loans to Women Update

We approved nine loans to women as the primary borrower in 2010 totaled \$964,694.00. As of this reporting, it should be noted that the majority of businesses that we have financed are managed by women.

V. Personnel Update

We had 37 employees as of December 31, 2010. We hired a new employee, Ms. Charito Soriano during the year to fill a new position in the accounting division.

Franky Eward, a loan officer in Pohnpei resigned to take up a new job with the Pohnpei Seventh-Day Adventist School as its new principle in June of 2010.

VI. Training Update

The following trainings were conducted in 2010:

1. An Advanced Development Workshop for our credit officers was conducted in Pohnpei in 2010. It was a one-week course conducted by Planters Development Bank. We assembled all of our credit officers in Pohnpei to attend this training.



2. SVP attended the first of three sessions for a 3-year certificate program at the Pacific Coast Banking School in Seattle, Washington.
3. The Branch Managers, the CFO and Loan Administrator attended part I & II of the Core Development Banking Course sponsored by ADFIAP in the Phillipines.

VII. Information System Update

Various improvements and updates were made to our information system which included the following.

- Purchased and installed updates to the accounting system.
- Upgraded the “Optimist” program.
- Discussion to update our website commenced towards the end of 2010. We will pursue a facelift to the website in 2011.

Overall, our information system remained adequate to support our operations. We will however continue to strive for improvements.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Bank will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Bank’s investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Bank’s name by the Bank’s custodial financial institutions at December 31, 2010 and 2009.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity’s investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Bank. As of December 31, 2010, the Bank’s investment in U.S. treasury notes and agency obligations of the Federal National Mortgage Association constituted 17% and 9%, respectively, of its total investments. As of December 31, 2009, the Bank’s investment in U.S. treasury notes and agency obligations of the Federal National Mortgage Association constituted 18% and 11%, respectively, of its total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Bank has a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Equity Investment, at Cost

The equity investment in Bank of the FSM, carried at cost, represents 100,000 common shares and approximately an 11% ownership interest. Since the book value of the shares exceeds the carrying value, management believes that the equity investment has not become impaired.

(4) Loans Receivable

A summary of loans receivable at December 31, 2010 and 2009 follows:

	<u>2010</u>	<u>2009</u>
Unpaid principal balance	\$ 27,152,788	\$ 28,426,407
Allowance for loan losses	<u>(6,199,117)</u>	<u>(5,789,261)</u>
	\$ <u>20,953,671</u>	\$ <u>22,637,146</u>

Movements in the allowance for loan losses during the years ended December 31, 2010 and 2009, are as follows:

	<u>2010</u>	<u>2009</u>
Balance at beginning of year	\$ 5,789,261	\$ 5,295,649
Reversal of provision for loan losses	(103,860)	(365,582)
Loans restructured	115,851	-
Loan recoveries from previously charged off loans	397,865	610,094
Loan reactivations from previously charged off loans	<u>-</u>	<u>249,100</u>
Balance at end of year	\$ <u>6,199,117</u>	\$ <u>5,789,261</u>

As of December 31, 2010 and 2009, investments at fair value are as follows:

	<u>2010</u>	<u>2009</u>
Fixed income securities:		
Domestic fixed income	\$ 2,907,993	\$ 3,019,931
Other investments:		
Domestic equities	5,229,535	4,600,775
Money market funds	<u>1,560,704</u>	<u>1,382,106</u>
	<u>\$ 9,698,232</u>	<u>\$ 9,002,812</u>

As of December 31, 2010 and 2009, the Bank's fixed income securities had the following maturities:

	2010	Less Than 1 Year	1 to 5 Years	6 to 10 Years	Greater Than 10 Years	Fair Value
U.S. Treasury obligations	\$ 316,611	\$ 316,611	\$ 972,193	\$ 388,883	\$ -	\$ 1,677,687
U.S. Government agency obligations	<u>244,824</u>	<u>244,824</u>	<u>616,767</u>	<u>368,715</u>	<u>-</u>	<u>1,230,306</u>
	<u>\$ 561,435</u>	<u>\$ 561,435</u>	<u>\$ 1,588,960</u>	<u>\$ 757,598</u>	<u>\$ -</u>	<u>\$ 2,907,993</u>
	2009	Less Than 1 Year	1 to 5 Years	6 to 10 Years	Greater Than 10 Years	Fair Value
U.S. Treasury obligations	\$ 160,619	\$ 160,619	\$ 1,257,781	\$ 158,564	\$ 73,369	\$ 1,650,333
U.S. Government agency obligations	<u>-</u>	<u>-</u>	<u>1,014,232</u>	<u>355,366</u>	<u>-</u>	<u>1,369,598</u>
	<u>\$ 160,619</u>	<u>\$ 160,619</u>	<u>\$ 2,272,013</u>	<u>\$ 513,930</u>	<u>\$ 73,369</u>	<u>\$ 3,019,931</u>

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

The Bank's exposure to credit risk at December 31, 2010 and 2009, was as follows:

<u>2010</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
Moody's Rating – AAA	\$ <u>2,907,993</u>	\$ <u>2,907,993</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>2,907,993</u>	\$ <u>2,907,993</u>	\$ <u>-</u>
	<u>2009</u>	<u>Total</u>	<u>Domestic</u>
Moody's Rating – AAA	\$ <u>3,019,931</u>	\$ <u>3,019,931</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>3,019,931</u>	\$ <u>3,019,931</u>	\$ <u>-</u>

VIII. Strategic Plan Update

Our strategies remain unchanged. As of year end 2010, we were pretty much in line with the strategic plan.

IX. Bank Facilities and Equipment Update

There were no significant changes to the bank facilities in 2010. We disposed and replace three bank vehicles during the year.

X. Programs Update

There were no new programs in 2010.

XI. Associations and Memberships Update

We remain active in the following professional associations.

- Association of Development Financial Institution Asia and Pacific (ADFIAP)
- Association of Developmental Financial Institutions of the Pacific (ADFIP).
- Association of the Pacific Island Public Auditor (APIPA)
- Asia Pacific Association for Fiduciary Studies (APAFS)
- Federated States of Micronesia Executive Insurance Board (FSMEIB)

As an active member of ADFIP, we had the privilege of hosting the 25th Annual General Meeting during the year. The theme selected for the meeting was "Climate Change and Innovative Development Financing in the Pacific". The meeting was a great success. In addition to remarks given by the Chairmen of the ADFIP and FSMDB board, we were honored to have the Honorable John Ehsa Governor of the State of Pohnpei and the Vice President of the FSM the Honorable Alik Alik give the welcoming remarks and key-note address respectively.



XII. Acknowledgements

We would like to take this opportunity and thank Franky Edward for his many contributions to the bank during his tenure. We wish him the best of luck in his new job.

We also want to take this opportunity and welcome Charito Soriano, who was hired during the year to take up a new position in the accounting division.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Bank does not have a deposit policy for custodial credit risk.

As of December 31, 2010 and 2009, the carrying amount of the Bank's total cash and cash equivalents and time certificates of deposit was \$7,830,737 and \$5,391,764, respectively, and the corresponding bank balances were \$7,935,602 and \$5,412,386, respectively. Of the bank balances, all are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2010, bank deposits in noninterest-bearing transaction accounts and interest-bearing transaction accounts in the amounts of \$250,164 and \$500,000, respectively, were FDIC insured. As of December 31, 2009, bank deposits in the amount of \$500,000 were FDIC insured. The Bank does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. Management's confidence in the financial strength of their banking institutions was the basis of the decision to not require collateralization. No losses as a result of this practice were incurred for the years ended December 31, 2010 and 2009.

B. Investments:

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

- Category 1 Investments that are insured or registered, or securities held by the Bank or its agent in the Bank's name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Bank's name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Bank's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

- (i) Government obligations - Obligations issued or guaranteed as to principal and interest by the National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.
- (ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or other mortgage-backed securities provided that the obligation is an agency of the United States Government, the National Government of the Federated States of Micronesia, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the investment fund or ten percent of the outstanding value of the issue at the time of purchase.
- (iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Bank's investment advisor at the time of purchase, that not more than five percent of the market value of its investments shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of its investments shall be invested in any one industry group.
- (iv) Insurance company obligations - Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in the Federated States of Micronesia or in any state, territory or commonwealth of the United States provided that the total market value of these investments at no time shall exceed ten percent of all investments.

A. Deposits:

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by the Bank or its agent in the Bank's name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Bank's name; or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Bank's name and non-collateralized deposits.

XIII. Special Acknowledgement

We want to extend a special recognition, appreciation and many thanks to Director Ramon Falcam who had served the bank as a director for many years. Director Falcam stepped down from his post during the year to enjoy retirement. We wish him and his family the best on his future endeavors.

We would like to also recognize and welcome Director Juliet Jimmy who was nominated to replace Director Ramon Falcam in 2010. Having had worked for the Department of Finance & Administration of the Pohnpei State Government for many years and at present with the Department of Finance of the FSM National Government, Ms. Jimmy brings to the board extensive knowledge and experience in financial matters.

Part 3: Financial Report

Figure 5: Total Revenue Trend 2006-2010

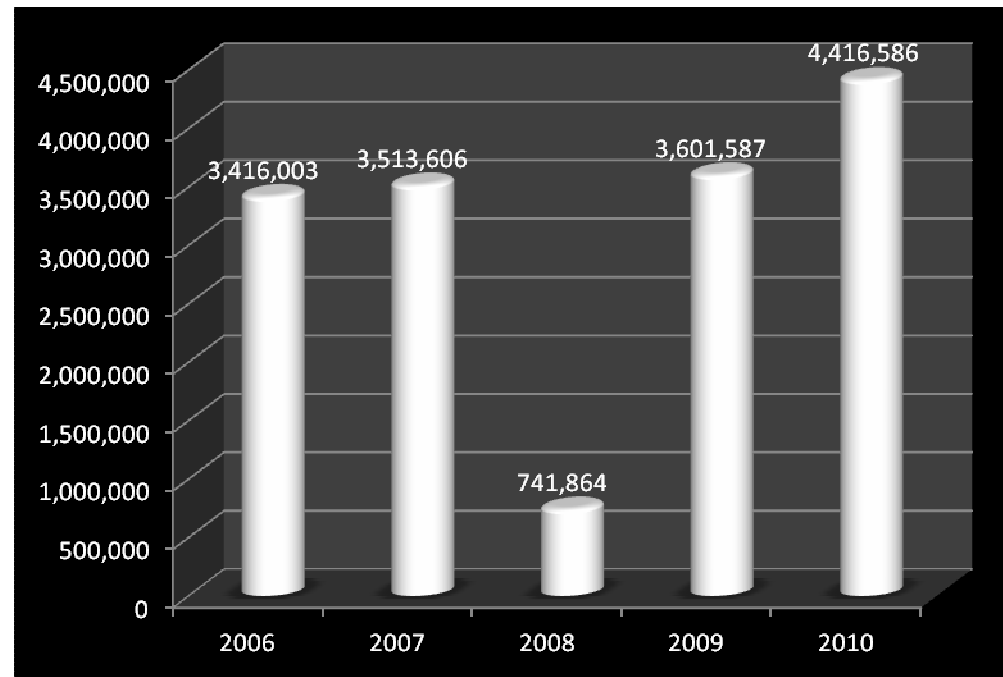
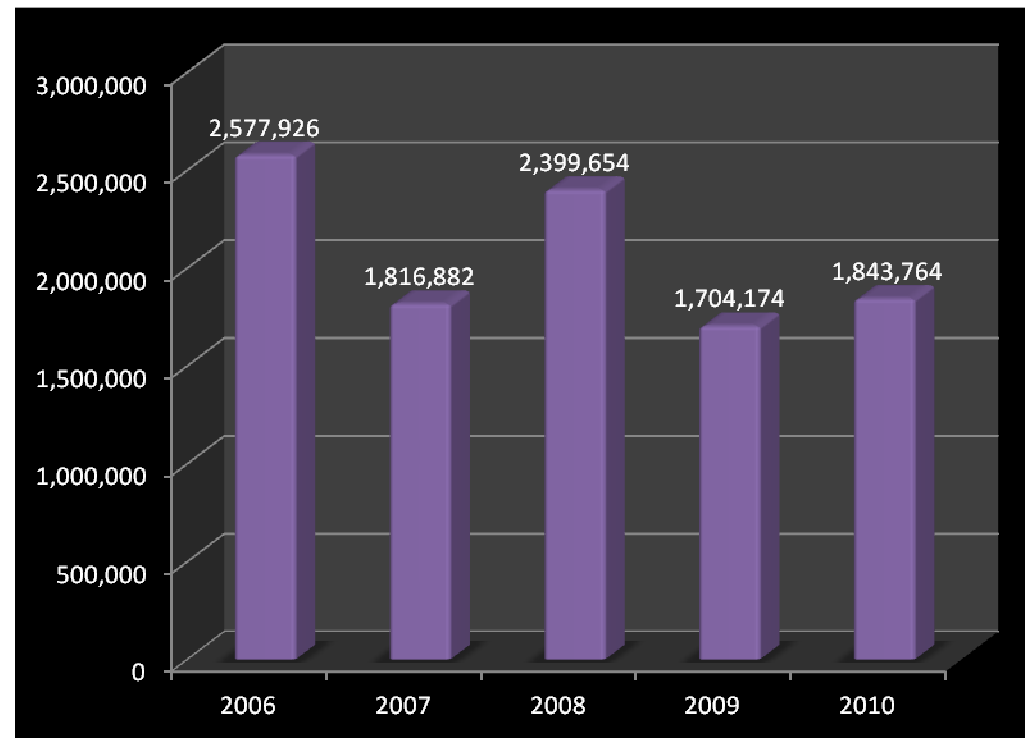


Figure 6: Total Expenditure Trend 2006-2010



- GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code, and establishes requirements for recognizing and measuring the effects of the bankruptcy process on assets and liabilities, and for classifying changes in those items and related costs.

The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

In March 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the Bank.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the Bank.

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of the Bank are governed by its enabling legislation. The Board is required to engage one or more fund custodians to assume responsibility for the physical possession of the Bank's investments. Legally authorized investments are as follows:

Fixed Assets

Fixed assets are stated at cost, less accumulated depreciation. Depreciation is based on the straight-line method over the estimated useful lives of the respective assets. All assets have estimated useful lives of three to five years.

The Bank's policy on fixed assets requires that assets with a purchase value of \$5,000 and over are capitalized and depreciated based on their useful lives. Assets with a purchase value less than \$5,000 are expensed fully in the year of purchase.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank enters into off-balance sheet financial instruments consisting of commitments to extend credit and loan guarantees. Such financial instruments are recorded in the financial statements when they become payable.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

Reclassifications

Certain reclassifications have been made to the 2009 financial statements in order to conform with the 2010 presentation.

New Accounting Standards

During fiscal year 2010, the Bank implemented the following pronouncements:

- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which addresses whether and when intangible assets should be considered capital assets for financial reporting purposes.
- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements.
- GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*, which clarifies the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, for calculating the annual required contribution (ARC) adjustment.

Figure 7: Net Profit Trend 2006-2010

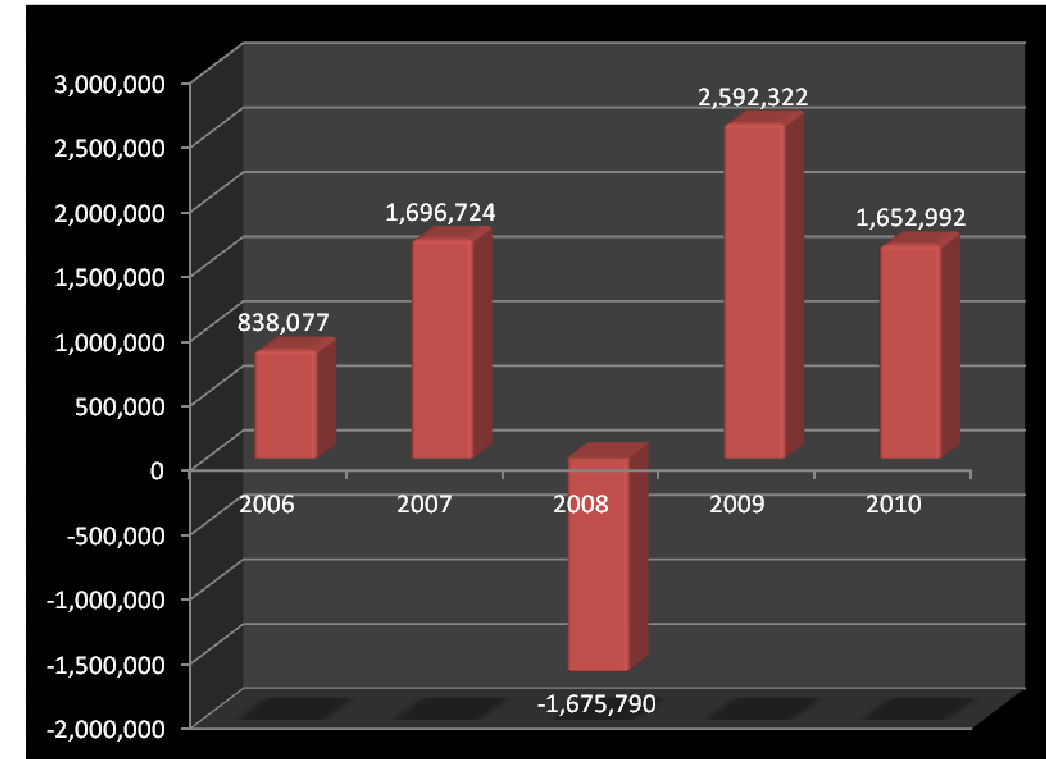
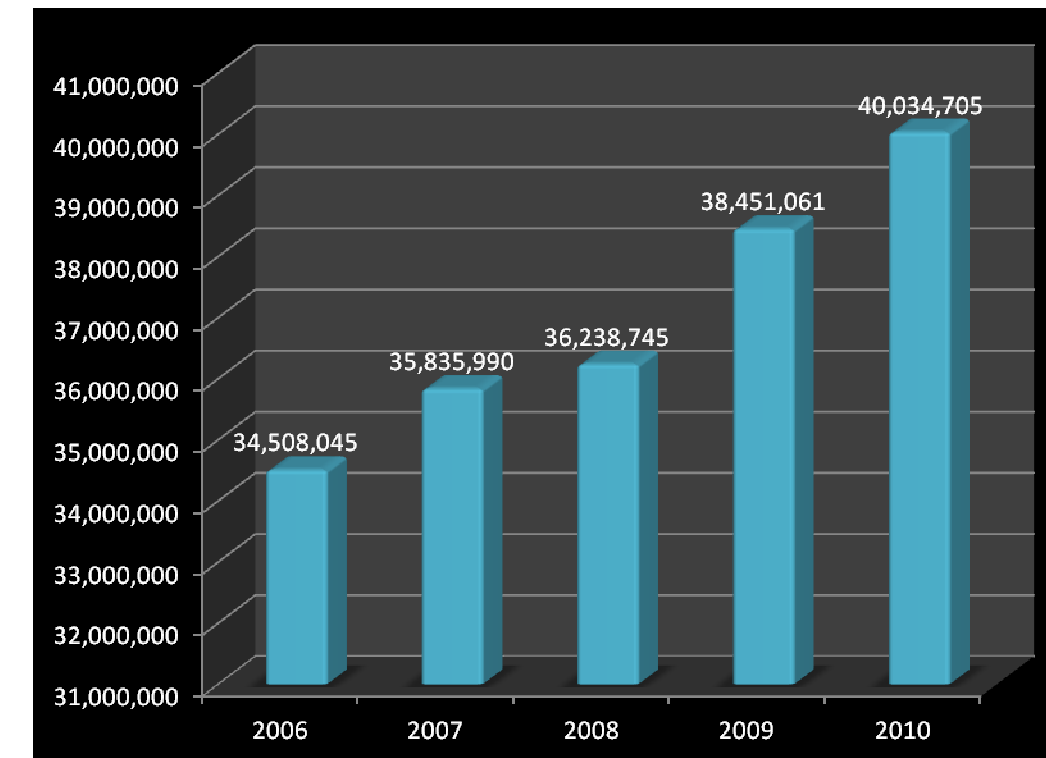


Figure 8: Total Asset Trend 2006-2010



Statements of Net Assets
December 31, 2010 and 2009

	2010	2009
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 5,609,400	\$ 3,283,875
Time certificates of deposit	1,701,042	1,589,936
Housing escrow account	520,295	517,953
Accounts receivable	19,704	11,034
Receivable from trust funds	400,624	358,844
Prepaid expenses	2,500	2,500
Interest and other receivables	237,596	160,323
Current portion of loans receivable	4,870,572	7,697,812
Total current assets	13,361,733	13,622,277
Noncurrent assets:		
Fixed assets, net	229,453	224,450
Investments	9,698,232	9,002,812
Equity investment, at cost	662,188	662,188
Loans receivable, net of current portion and allowance for loan losses	16,083,099	14,939,334
Total noncurrent assets	26,672,972	24,828,784
Total assets	\$ 40,034,705	\$ 38,451,061
<u>LIABILITIES</u>		
Current liabilities:		
Current portion of long-term debt	\$ 400,000	\$ 400,000
Accounts payable	184,130	129,902
Accrued interest payable	45,264	52,732
Credit life payable	23,519	8,322
Payable to trust funds	188,374	36,243
Total current liabilities	841,287	627,199
Noncurrent liabilities:		
Long-term debt, net of current portion	916,564	1,200,000
Total liabilities	1,757,851	1,827,199
Commitments and contingencies		
Net assets:		
Invested in capital assets	229,453	224,450
Unrestricted	38,047,401	36,399,412
Total net assets	38,276,854	36,623,862
Total liabilities and net assets	\$ 40,034,705	\$ 38,451,061

See accompanying notes to financial statements.

For the years ended December 31, 2010 and 2009, the Bank does not have expendable or nonexpendable restricted net assets.

• Unrestricted:

Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. All other revenues are reported as nonoperating. Operating expenses includes the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Cash and Cash Equivalents

For the purposes of the statements of net assets and the statements of cash flows, cash and cash equivalents are defined as cash in bank checking and savings accounts, money market funds, and commercial paper with original maturities of three months or less from the date of acquisition.

Time certificates of deposit with original maturities of greater than three months are separately classified.

Investments

Investment securities and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale and is primarily determined based on quoted market values.

An equity investment in the common stock of Bank of the FSM is stated at cost as there is no market for this investment.

Loans and Allowance for Loan Losses

Loans receivable are stated at unpaid principal balance less the allowance for loan losses.

Management maintains the allowance for loan losses at a level adequate to absorb probable losses. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. Loans deemed uncollectible are charged to the allowance. Provisions for losses and recoveries on loans previously charged off are added to the allowance.

Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

Fund Structure and Basis of Accounting

The accounts of the Bank are organized as a discretely presented component unit - proprietary fund of the FSM National Government. Proprietary funds are used by governmental units to account for operations that are financed and operated in a manner similar to a private business. This accounting is appropriate when costs of providing goods or services to the general public are to be financed primarily through user charges or where the periodic determination of net income is appropriate for accountability purposes. The accrual basis of accounting is utilized by proprietary funds. Under the accrual basis, revenues are recorded when earned, and expenses are recorded at the time the liabilities are incurred.

The accounts of the IDF, PDLF and YDLF are accounted for as fiduciary fund types as the amounts are to be reported on the respective entities' financial statements (the FSM National Government, Pohnpei State and Yap State, respectively).

The Bank utilizes the flow of economic resources measurement focus. Its financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to governmental units using the accrual basis of accounting. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting* requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Bank has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The Bank has adopted GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments* (GASB 34) as amended by GASB Statement No. 37, *Basic Financial Statements – Management's Discussion and Analysis-for State and Local Governments: Omnibus* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following four net asset categories:

- Invested in capital assets, net of related debt:

Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require the Bank to maintain them permanently.
 - Expendable – Net assets whose use by the Bank is subject to externally imposed stipulations that can be fulfilled by actions of the Bank pursuant to those stipulations or that expire by the passage of time.

Statements of Revenues, Expenses and Changes in Net Assets Years Ended December 31, 2010 and 2009

	2010	2009
Operating revenues:		
Interest income on loans	\$ 2,239,484	\$ 2,212,585
Interest income on time certificates of deposit	37,866	44,982
Loan fees	101,094	190,949
Miscellaneous	65,832	51,491
Total operating revenues	2,444,276	2,500,007
Reversal of provision for loan losses	103,860	365,582
Net operating revenues	2,548,136	2,865,589
Operating expenses:		
Interest expense:		
Interest on long-term debt	104,831	120,090
General and administrative expenses:		
Personnel services	1,002,303	941,549
Contractual services	167,657	113,015
Rent	122,983	121,967
Depreciation	94,925	80,936
Travel	89,367	76,734
Training	85,243	60,501
FSM retirement plan	56,824	51,395
Communication	37,960	36,840
Supplies	19,006	18,601
Insurance	5,581	5,265
Printing	1,092	6,730
Miscellaneous	160,823	190,641
Total general and administrative expenses	1,843,764	1,704,174
Earnings from operations	599,541	1,041,325
Non-operating revenues:		
IDF reimbursement	250,000	250,000
Allocations from managed funds	-	13,734
Investment earnings, net	803,451	1,286,632
Other income	-	631
Total non-operating revenues, net	1,053,451	1,550,997
Change in net assets	1,652,992	2,592,322
Net assets at beginning of year	36,623,862	34,031,540
Net assets at end of year	\$ 38,276,854	\$ 36,623,862

See accompanying notes to financial statements.

Notes to Financial Statements

Statements of Cash Flows
Years Ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Cash received from customers	\$ 2,319,004	\$ 2,458,187
Cash paid to suppliers for goods and services	(677,110)	(664,738)
Cash paid to employees for services	(1,002,303)	(941,549)
Interest received on time certificates of deposit	39,328	121,309
Interest paid	(112,299)	(137,261)
Net cash provided by operating activities	<u>566,620</u>	<u>835,948</u>
Cash flows from noncapital financing activities:		
Proceeds from long-term debt	116,564	-
Principal repayment of long-term debt	(400,000)	(400,000)
Net transfers in from trust funds	360,351	150,311
Net cash provided by (used for) noncapital financing activities	<u>76,915</u>	<u>(249,689)</u>
Cash flows from capital and related financing activities:		
Acquisition of fixed assets	(99,928)	(78,821)
Net cash used for capital and related financing activities	<u>(99,928)</u>	<u>(78,821)</u>
Cash flows from investing activities:		
Loan origination and principal collections, net	1,787,335	(2,085,613)
Additions to time certificates of deposit, net	(111,106)	(1,008,151)
Change in escrow accounts, net	(2,340)	(7,410)
Withdrawals from investments	-	2,600,000
Investment income received	130,656	106,921
Investment fees paid	(90,627)	(113,269)
Dividends received	68,000	60,000
Net cash provided by (used for) investing activities	<u>1,781,918</u>	<u>(447,522)</u>
Net change in cash and cash equivalents	2,325,525	59,916
Cash and cash equivalents at beginning of year	3,283,875	3,223,959
Cash and cash equivalents at end of year	<u>\$ 5,609,400</u>	<u>\$ 3,283,875</u>
Reconciliation of earnings from operations to net cash provided by operating activities:		
Earnings from operations	\$ 599,541	\$ 1,041,325
Adjustment to reconcile earnings from operations to net cash provided by operating activities:		
Reversal of provision for loan losses	(103,860)	(365,582)
Depreciation	94,925	80,936
(Increase) decrease in assets:		
Accounts receivable	(8,670)	(4,441)
Prepaid expenses	-	200
Interest and other receivables	(77,273)	83,929
Increase (decrease) in liabilities:		
Accounts payable	54,228	18,853
Accrued interest payable	(7,468)	(17,170)
Credit life payable	15,197	(2,102)
Net cash provided by operating activities	<u>\$ 566,620</u>	<u>\$ 835,948</u>

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies

Reporting Entities

The Federated States of Micronesia (FSM) Development Bank (the Bank) was created in 1979 by Public Law 1-37 of the First Congress of the Federated States of Micronesia. The Bank began its operations on October 1, 1980. The Bank was reorganized in January 1994 by Public Law 8-47 of the Eighth Congress of the Federated States of Micronesia. The purpose of the Bank is to provide loans for economic development of the FSM. Such loans may otherwise be too risky for commercial banks to underwrite. Additionally, the Bank's repayment terms tend to be longer than those offered by commercial banks. As of December 31, 2010, the Bank has issued 2,997,883 shares to the FSM National Government (98.7%), Kosrae State (0.3%) and Chuuk State (1.0%). These shares do not convey ownership and have been made in accordance with the aforementioned law but these shares have no financial impact on the accompanying financial statements.

The Investment Development Fund (IDF) was established by Public Law 5-122 in January 1989. The purpose of the IDF is to finance projects which will (1) have their operations primarily located within the FSM; (2) improve the balance of payments position of the FSM; (3) increase the value of visible and invisible exports or result in import substitutions; (4) demonstrate positive economic returns; (5) contribute to the furtherance of close economic relations with the USA.

The Pohnpei Development Loan Fund (PDLF) and the Yap Development Loan Fund (YDLF) are administered by the Bank in a Trust capacity. All loan decisions are made by executives of the respective state governments.

The Bank is a component unit (a discretely presented proprietary fund type) of the FSM National Government. The financial statements in this report do not represent the financial position, results of operations or cash flows of the FSM National Government as a whole. The financial statements of the Bank are not obligations of the FSM National Government unless specifically authorized by the FSM National Government. To date, no such authorizations have been made.

The Bank has opted to establish itself more in line with a corporate model. The Bank, through this process, hopes to be able to attract additional capital through non-FSM sources. To that end, the Bank, in September 2007, entered into a line of credit agreement with Export and Import Bank of China for \$2,000,000. As of December 31, 2010 and 2009, the amount outstanding and payable under this line was \$1,200,000 and \$1,600,000, respectively. Additionally, the Bank has entered into a memorandum of understanding with the U.S. Department of Agriculture's Office of Rural Economic and Community Development to provide guarantees for housing loans in the FSM. An escrow account amounting to \$520,295 and \$517,953, respectively, as of December 31, 2010 and 2009, was established for the housing guarantee.