Progress Report on Tranche Release

Program Number: 33314
Loan Number: 1873
December 2006

The Federated States of Micronesia: Private Sector Development Program Loan

Asian Development Bank

CURRENCY EQUIVALENTS

The Federated States of Micronesia uses the US dollar as its currency.

ABBREVIATIONS

ADB	–	Asian Development Bank
FIAS	–	Foreign Investment Advisory Service
FIAS I	–	First round of FSM foreign investment reform
FIAS II	–	Second attempt at foreign investment reform
FSM	–	Federated States of Micronesia
PSDP	–	Private Sector Development Program
PSE	–	Public Sector Enterprise

NOTES

(i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g. FY2001 ends on 30 September 2001.

(ii) In this report, "$" refers to US dollars.

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I. INTRODUCTION

1. The Asian Development Bank (ADB) approved two loans to the Federated States of Micronesia (FSM) for the Private Sector Development Program (PSDP) on 12 December 2001: a program loan (the Program) of SDR3.912 million or $5.0 million equivalent, and a project loan of SDR6.273 million or $8.017 million equivalent, both to be financed from ADB's Asian Development Fund.[1] The loan agreements were signed on 24 January 2002, and the loan became effective on 24 April 2003. The Program is tailor-made to meet individual states' needs. The Project is expected to be completed on 31 October 2007, although a recent request has been approved extending the completion date until 31 March 2008 to ensure all activities are completed.

2. The Program provides for achieving a set of national economic targets supportive of increased private sector activity. These comprise maintaining a balanced budget, reducing wage differentials between the public and private sectors, contributing additional Compact funds to the FSM Trust Fund, and keeping external debt below 24% of GDP. It provides support to implementing public sector enterprise reforms, revising and putting into effect laws to improve the use of land and property as loan security, and improving foreign direct investment laws and regulations at the national and state levels. The loan also provides for some adjustment costs relating to the reforms.

3. The Program complements the investment loan that provides funding to implement changes benefiting the private sector. The Project has four components: Small Business Development Centers, support to FSM Development Bank, Land Management, and Secured Transactions. Further, small-scale technical assistance[2] was approved in December 2004 to support the governments in fulfilling conditions for release of the second tranche under the PSDP. Intended outputs included enactment and promulgation in each of the states and at national level of legislation for foreign direct investments, long-term leasing of land, mortgage-secured lending, and at least one public enterprise transformed in each of the four states and at national level.

4. Proceeds from the Program were scheduled for release in two tranches. The conditions for release of the first tranche were met by all governments at the time of the inception mission in May 2003. The release for Chuuk was delayed 12 months until that state had passed the necessary authorizing legislation and ratified its relending agreement with the Borrower. A total $1.85 million was released under the first tranche of the policy loan for Kosrae, Pohnpei, and Yap, as well as the FSM Government on 31 July 2003. The first tranche for Chuuk ($650,000) was released on 30 July 2004.

5. The FSM comprises more than 600 islands covering 702 square kilometers (km^2) of land area scattered over 2.6 million km^2 in the western central Pacific Ocean. The islands are divided among four states: Chuuk (133.8 km^2), Kosrae (117.4 km^2), Pohnpei (360.6 km^2), and Yap (125 km^2) with the national Government located in Pohnpei at Palikir. The population was estimated to be 108,300[3] in 2005, with approximately half in Chuuk and the rest spread between the other three states.

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[1] ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Federated States of Micronesia for the Private Sector Development Program*. Manila.

[2] ADB. 2004. *Technical Assistance to the Federated States of Micronesia for the Legislation for Private Sector Development.* Manila (SSTA 4539-FSM, approved on 23 December 2004 for $150,000).

[3] FSM FY2005 Compact Annual Report Statistical Tables.

6. Both the national and state governments have executive branches headed by the president (national) or governors (states) and independent legislatures (two houses in Chuuk, but one only in the national government and the other states). The passing or amending of legislation requires extensive, time-consuming consultation in order to get the agreement of both the executive and the legislature.

II. THE ECONOMY AND PRIVATE SECTOR REFORMS IN FSM

7. The FSM's political and economic ties with the US through the treaty known as the Compact of Free Association places the country in a unique situation. The treaty was drafted to last indefinitely, but the provisions under Title Two, Economic Relations, are time-bound and expired in FY2001. The Compact was amended in 2003 and extended until 2023. Funding from the US over this period is $92.7 million per annum adjusted by two thirds of the US gross domestic product implicit price deflator or 5%, whichever is smaller. In the first 3 years of the amended Compact $76.7 million of these funds were for the current operations of the state and national Governments, and the balance of $16 million was paid into the trust fund to be used in financing current expenditure when the Compact ends. Funding under the Compact and other grants was estimated to be 60% of total consolidated government revenue of $127.3 million in 2005 (footnote 2). From FY2007 the amount paid for current operations will decrease by $800,000 per year, and the amount paid into the trust fund will increase by a corresponding amount.

8. In FY2001, government services was the largest single sector in the economy, comprising 23% of GDP. The second-largest sector was wholesale and retail, which had grown largely in response to the spending power of Government workers. Subsistence production from agriculture and inshore fishing was estimated to be the third-largest sector. At that time, the level of future funding under the Compact was uncertain. As a result, there was an increasing realization among political leaders and others in the FSM that future economic growth and employment would have to come from increased private sector activity.

9. Reviews by the Foreign Investment Advisor Service[4] (FIAS), ADB technical assistance,[5] the FSM Banking Symposium, and the 1st Economic Summit indicated there were significant impediments to both foreign and local investments. These impediments included (i) lack of clarity in foreign investment laws and regulations; (ii) land tenure issues related to adjudication, survey, registration, and issuance of land titles; (iii) significant government involvement in business which was crowding out the private sector; and (iv) difficulties for business to access credit.

10. In response to these concerns about constraints to growth of the private sector, ADB was requested to develop a program to address some of the issues.

11. Economic growth in FSM was 2.9% in FY2002, 4.3% in FY2003, –3.5% in FY2004, and 1.4% (estimate) in FY2005. These fluctuations can in part be attributed to delays in the release of some funding under the Compact, especially for infrastructure.

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[4] FIAS is funded by the World Bank and IFC. The first study was undertaken in approximately 1997 and there was a follow-up in 1999.

[5] ADB. 1997. *Technical Assistance to the Federated States of Micronesia for Improved Economic Use of Land*. Manila (TA 2758, approved on 7 February 1997).

The release of significant amounts for infrastructure is expected to provide a stimulus to the economy.

12. It is still too early to evaluate whether PSDP initiatives are resulting in greater economic activity, although they are contributing to the foundations for future growth of the private sector. The generally poor job prospects in FSM result in continued migration to the US,[6] and this will relieve some pressure resulting from the slow economic growth.

III. PROGRAM IMPLEMENTATION

A. Project Management and ADB Assistance

13. The PSDP project implementation unit maintained consultations with all governments on the requirements for the second tranche conditions. Nevertheless, delays in fulfilling the requirements were noted during a review mission in October 2004. These were due to (i) lack of a common understanding of specific measures required to comply with the policy loan conditions, (ii) low appreciation for the benefits of reform, and (iii) insufficient capacity in governments to carry out the required legislative and regulatory reform. These constraints were most pronounced in the legal area.

14. To assist governments in moving towards compliance with the second tranche policy loan conditions, ADB approved in December 2004, in consultation with the Government, small-scale technical assistance[7] to advise and guide the governments. A consultant was fielded for 6 months from May 2005.

15. The consulting services were rated as satisfactory and did assist the Governments to meet the conditions.

B. Status of Second Tranche Release Conditions

16. Several conditions were established for each FSM government for release of the second tranche. These must be met by the national Government and at least two state governments before any funds will be released. The conditions are: (i) maintaining balanced national and state government budgets, (ii) maintaining government payrolls, (iii) soundly managing the FSM Trust Fund, (iv) soundly managing external debt, (v) making progress in public enterprise reforms, (vi) amending foreign investment laws and regulations, and (vii) passing legislation to improve the legal environment for long-term leasing of land and encouraging mortgage-secured commercial lending.

17. The second tranche release was due in August 2003. The FSM subsequently requested this be extended until April 2005, then November 2005, and finally 30 June 2006.

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[6] Exact statistics on migration are not available. Estimates based on civil aviation figures and anecdotal evidence indicate that 1,000 to 2,000 people are migrating per year.

[7] ADB. 2004. *Technical Assistance to the Federated States of Micronesia for Legislation for Private Sector Development*. Manila (TA 4539 approved on 23 December 2004).

Table 1: First and Second Tranche Amounts
($)

Government	First Tranche	Second Tranche	Total
National	500,000	500,000	1,000,000
Chuuk	650,000	650,000	1,300,000
Kosrae	400,000	400,000	800,000
Pohnpei	550,000	550,000	1,100,000
Yap	400,000	400,000	800,000
Total	**2,500,000**	**2,500,000**	**5,000,000**

Source: ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Federated States of Micronesia*. Manila.

1. Maintain Economic and Public Sector Reforms

a. Maintenance of Balanced Budgets

18. The policy conditions required the national and state governments to (i) maintain balanced budgets and (ii) keep payrolls below certain specified levels while limiting annual increases in these to 1.5% per annum. This was particularly important for fiscal years 2002 and 2003 while the amendments to the Compact were being negotiated. During these 2 years, there were "bump-ups" in funding that would not be repeated. The aim of these conditions related to sound fiscal management were to ensure that the governments did not increase spending to levels that could not be maintained in the future. These conditions were met by all Governments.

b. Maintenance of Government Payroll Levels and Reduction of Public to Private Sector Wage Differentials

19. The oversight by the Joint Economic Management Committee of the Compact is likely to assist FSM to maintain sound fiscal discipline and control wages budgets in the future. Funding not provided under the Compact will have to come from such local revenue sources as taxation, fishing licenses, and other government revenue. There are moves to introduce taxation reform, including to create a value-added tax, which would provide additional local revenue, but progress to date has been slow. There is a general awareness among politicians and officials that it is not wise to increase borrowing when the major source of funding is decreasing in real terms.

c. Sound Management of the FSM Trust Fund

20. This condition required that not less than 50% of the increased budgetary support under the Compact Base Grant for FY2002 and FY2003 be dedicated to the stability account of the FSM Trust Fund. An objective of this condition was to help maintain fiscal discipline during the 2 years of "bump-ups" of Compact funds. In addition, there was an aim to encourage the Government to start putting funds into a trust fund for when the Compact will end.

21. The increase in budgetary support was $17 million in each year. On 30 September 2004 the Borrower transferred $30 million to the new Trust Fund for the People of Micronesia established under the amended Compact, comfortably exceeding the minimum requirement. This condition has been met.

22. The US will continue to contribute to the Trust Fund. This will build up substantial reserves for FSM but, based on most likely returns on investment, it will not be sufficient to match even the reduced annual payments under the Compact in its later years. Other sources of Government revenue will be needed at the end of the Compact to supplement payments from the Trust Fund in order to maintain expenditure levels.

d. Sound Management of External Debt

23. In 1995, FSM's external debt, net of assets held for repayment, was 35% of GDP. The level of debt decreased thereafter and was 19% of GDP in 2001. There was concern, however, that if there were financial constraints the Governments might resort to additional external borrowing. The condition included was that total official debt, net of assets held to secure repayment, should remain below 24% of GDP.

24. The external debt, net of assets held for loan repayments, was 18% as of 30 September 2002, 17% as of 30 September 2003, 17% as of 30 September 2004, and 16% as of 30 September 2005. This is a prudent level of debt that is within the capability of the FSM to repay. There is a general understanding that borrowing should be undertaken in a cautious manner. This condition has been met.

e. Progress in Public Enterprise Reforms

25. Much of the groundwork for current public sector enterprise (PSE) reform was laid with the support of ADB technical assistance.[8] The final report from that assistance identified a variety of activities that could constitute PSE reform, including liquidation, divestiture, corporatization, commercialization, governance reform, and outsourcing of goods or services. A PSE can be any commercial activity conducted by a public entity, whether lodged in a government department or a separate legal entity owned by the government. Thus, the opportunities for PSE transformations are many, and reforms falling far short of classic privatization can potentially qualify as transformations.

26. In order to qualify for the second tranche, each of the FSM national and state governments had to transform at least one PSE. In deciding whether a transformation met the condition, it was assessed whether it reduced government costs, improved service, and reduced crowding out of the private sector. Generally, at least two of these conditions had to be indicated to constitute a successful transformation. An exception was made if only one was indicated, but dramatically so.

27. **National Government.** The national capital water system was transferred from a Government department to a Pohnpei state-owned utility corporation. This resulted in a clear service improvement and clear cost savings to the national Government. Whether the utility company has realized overall cost savings is yet to be quantified. As a result, the national Government has complied with its condition on PSE transformation.

28. The national Government did genuinely try to lease out the National Aquaculture Center and the Coconut Development Authority, although legal and other constraints have meant that these have not been successful to date.

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[8] ADB. 1999. *Technical Assistance to Federated States of Micronesia for Privatization of Public Enterprises and Corporate Governance Reforms*. Manila. (TA 3201 approved on 9 June 1999).

29. **Chuuk State**. Chuuk originally proposed contracting out management of its ice-making plant or the catering of meals at its public high school. The consultant also examined a failed past attempt at transforming the Chuuk Coconut Authority. Although there was no great political objection to these transformations, the Chuuk authorities could not make any progress on implementation, even with considerable assistance under the related ADB TA-4539 (footnote 2). Accordingly, Chuuk State has not complied with its condition on PSE transformation.

30. **Kosrae State**. Of all the FSM governments, Kosrae probably has the least real appreciation of the need for true privatization, although there was a greater interest in outsourcing of government activities. Limited government revenue in the future will constrain its ability to be involved in PSEs. Possibly the most promising of the options now underway in Kosrae involves transferring water supply to the state utility authority—in effect corporatizing and commercializing it—but this will not happen soon.

31. Given Kosrae's ready cooperation on all the other conditions, efforts were made to assist with, or identify, a transformation that would meet the requirements. Options discussed and considered with the state officials were the outsourcing of hospital equipment maintenance, outsourcing of school custodians and grounds maintenance, divesting the public works construction arm, as well as outsourcing school bus service and mortuary services arrangements. Some had occurred before inception of the PSDP loan, some were going nowhere at the moment, some were not transformations at all.

32. Kosrae did attempt to outsource the catering service at the hospital and did issue invitations for bids. However, no successful responsive bid was received. Kosrae has successfully outsourced the feeding program for its early childhood education centers. An invitation to bids was issued and, after reviewing these, three contractors were selected to provide the food to the various centers around the island. This increased the number of children receiving these meals and it is not crowding out the private sector. Kosrae has complied with its condition on PSE transformation.

33. **Pohnpei State**. Early in 2005, Pohnpei's Economic Development Authority sold three fishing vessels to a private company, resulting in significant financial benefit to the public and less crowding out of the private sector. This was primarily motivated by financial constraints facing the Government and its inability to provide further capital injections, rather than its being an intention to satisfy a loan condition.

34. In 2006, the state has leased the facilities of Carolina Fisheries Company and the Pohnpei Fishing Company. These actions were also forced upon the government because it was unable to inject additional funds into these loss-making companies. Nevertheless, these are significant transformations. Pohnpei State has complied with its condition on PSE transformation.

35. The loan-related transformation actually proposed by the state was to complete the corporatization of its radio station that had been mandated by law more than 10 years earlier. Various consultancies have focused on this over the last 10 years but it remains uncompleted. This is most likely due to capacity limitations, resistance by those who might be affected, and some lack of political will to force it through.

36. **Yap State**. Yap has transferred its television service from within a state department to FSM Telecom, in effect corporatizing and commercializing it. A subsidized, free service has been upgraded and placed on a fee-for-service basis. The improvement in service is substantial. Savings to the government are small but real. There is arguably less crowding out of the private sector. As a result, Yap has complied with its condition on PSE transformation.

37. Yap has made some steps towards corporatizing public transportation but this has not been completed.

2. Improve Legal Environment for Private Sector Development

a. Land Leasing and Mortgage Reform

38. The FSM Constitution prohibits ownership of land by noncitizens. The constitutions of two states—Kosrae and Pohnpei—prohibit ownership even by citizens from other states in the FSM. Removing or even loosening these restrictions may never happen, yet availability of land for development and as collateral for financing is critical if there is to be significant private sector development.

39. With this dilemma in mind, ADB sponsored technical assistance in 1999 to develop the necessary legal framework and model forms for a system of long-term land leasing and mortgage reform in the FSM. The resulting report[9] became the basis for the second tranche requirement that "[t]he legislative branches of the States shall have passed legislation improving the legal environment for long-term leasing of land and for encouraging mortgage-secured commercial lending."

40. This loan condition differs from the one regarding foreign investment in several ways. First, it requires only legislative action. Unlike foreign investment regulation, no implementing regulations are needed.

41. Second, it requires no action by the national Government. While the 1999 report included a proposed national leasing policy, this was primarily because the terms of reference called for it. In fact, land is of purely local concern in the FSM and the states alone can take all the action that needs to be taken in this area.

42. Third, with one exception, it does not require alteration of existing statutes, which can constitute a psychological obstacle to change. The exception is Pohnpei, which has had a "Development Leasehold Act" since 1996. That statute took an approach to long-term leasing that differs substantially from the approach recommended in the 1999 land leasing report. In particular, the Pohnpei act calls for intrusive and case-by-case intervention by the state government in what should essentially be a private contract between private parties. This and other drawbacks created a fear that the Pohnpei act was more likely to deter than attract long-term leasing, a fear arguably borne out by the almost complete lack of activity under the Act since its adoption nearly a decade ago.

43. Although the 1999 land leasing report recommended allowing terms of up to 99 years, terms as short as 50 years are adequate in almost all circumstances. Fifty-five

[9] ADB. 1999. *Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging.* Manila (TA 2758).

years may be better than 50 years in some cases, but either is good enough. Right now, Chuuk has a maximum term of 99 years, Kosrae has 55 years, and, for citizens, Yap has less than 50 years, as its constitution prohibits leases to foreigners of over 50 years. A proposed amendment to the Constitution increasing this period will go before the voters in November 2006. Only Pohnpei presents a problem here. The Pohnpei Constitution prohibits leases in excess of 25 years unless otherwise provided by legislation. The only such provision made by the legislature is the Development Leasehold Act described in the previous paragraph. While that Act permits terms of up to 55 years, it applies only to some commercial leases.

44. Thus, except for Pohnpei, the length of lease terms is not a problem. But the model leasing act addresses many other issues of concern. A discussion of those concerns, as well as the issues addressed by the model mortgage act, may be found in the 1999 land leasing report, portions of which are attached hereto as Appendix 1 for the convenience of the reader.

45. **Chuuk State**. At inception of the consultancy, Chuuk was the only state to have adopted new legislation in this area. Known as the "Chuuk State Land Leasing and Lease-Based Mortgage Act," it became law in 2003. Unfortunately, it has numerous shortcomings compared to the 1999 model acts upon which it is based. It combines into one statute what were originally two model acts—one for leasing and one for mortgaging (which covers more than just lease-based mortgages). In the process of consolidation, significant provisions of each model act were deleted or diluted. A more detailed critique of the existing statute is attached as Appendix 2.

46. The state was urged to reinstate the missing or altered provisions by amending the 2003 Act. No opposition to correcting the Act ever materialized, but the proposal fell victim to the same inertia that doomed foreign investment reform in Chuuk. The specific leasing and mortgage bills worked out in the first visit to Chuuk were never even submitted to the Legislature. If Chuuk had otherwise met its second tranche conditions, it might have been possible to consider the existing Chuuk law as acceptable. Chuuk State has not complied with its condition on land leasing and mortgage reform.

47. **Kosrae State**. Early in the consultancy, the Kosrae legislature passed bills to establish a Kosrae Leasehold Act (L.B. No. 8-116) and a Kosrae State Mortgage Act (L.B. No.8-66). Both were clearly based on the 1999 model acts, but the leasing bill incorporated some unfortunate changes to the model, and the mortgage bill contained numerous clerical errors, some potentially significant.

48. While the mortgage act and probably the leasing act would have been acceptable without change, the consultant, along with state lawyers urged correction. The Legislature was amenable, and suitable amendments were enacted in September 2006 and signed into law on 1 November 2006 (S.L. 8 -131). As a result, Kosrae State has complied with its condition on land leasing and mortgage reform.

49. **Pohnpei State**. From the beginning, Pohnpei had no intention of changing its current leasing approach to something more in line with the model leasing act. Accordingly, the consultant focused on whatever improvements might be possible to the existing Pohnpei act. Legislative Counsel had prepared a bill, designed to satisfy the second tranche condition, for the state legislative session that began at the same time

as this consultancy. It appeared to be a positive step but needed to go farther if it was to have any significant impact.

50. The situation regarding mortgaging was more promising. Here, too, a bill had been drafted with the second tranche in mind, but it, unlike the leasing bill, was similar to the model act.

51. Consultations to seek more improvement to both the leasing and mortgage bills went well, and bills sufficient to satisfy the second tranche condition were introduced on 29 June 2005. However, they never advanced within the legislature. While they did not appear to have any real opposition, neither did they have any indigenous champions. According to several observers, once the government realized it was unwilling to qualify on foreign investment reform, it lost interest in the other reforms as well. As a result, Pohnpei State has not complied with its condition on land leasing and mortgage reform.

52. **Yap State**. Yap had not taken any action on either land leasing or mortgage reform prior to assistance from TA-4539 (footnote 2). The consultant urged enactment of the two model acts, revised as appropriate for Yap. The executive branch was supportive but took a long time vetting the bills through its Private Sector Development Steering Committee and getting them sent over to the legislature. The Legislature did pass the amendments to the long-term leasing of land legislation in 2006, but did not pass the mortgage reform legislation. As a result, Yap State has not complied with its condition on land leasing and mortgage reform.

b. Foreign Investment Laws Amended and Regulations Implemented

53. Until the late 1990s, control of foreign investment in the FSM was by the national Government, pursuant to an outdated law from the United Nations Trust Territory days. The states complained about slow processing, insufficient sensitivity to local concerns, and the national Government's usurpation of power. Except for a few business sectors of undisputed national interest, there was general agreement at all levels in the FSM that decentralizing control of foreign investment to the states was a good idea.

54. While the states sought decentralization, development experts and foreign investors were concerned about the restrictiveness and lack of transparency in the existing law. FIAS, a joint facility of the International Finance Corporation and World Bank, was requested to do a review. The resulting report (known along with the related reforms of the late 1990s as FIAS I) proposed the "stoplight system" of red, amber, and green lists that was subsequently adopted by the national Government in 1997 and three of the states soon thereafter. (Pohnpei already had a foreign investment control regime of its own design at that time and did not wish to adopt the same approach as the other FSM governments).

55. The FIAS I proposals had four goals: (i) decentralization, (ii) uniformity of structure, (iii) making the rules less restrictive, and (iv) making the rules more transparent. Only the first of these goals was achieved, and this came at considerable cost. Perhaps the greatest cost was that a foreign investor wishing to engage in business in two or more states—for example, a lawyer representing clients throughout the FSM—could no longer do so by obtaining a single national foreign investment permit, but had to obtain a permit from each state. Apparently, this cost was believed to

be worthwhile in light of the other expected benefits. For the most part, however, those other benefits never materialized because the reform's other three goals were not achieved.

56. Uniformity in the structure of all five laws—although not necessarily in the specific policies expressed through that structure—was seen as important for two reasons. The laws would be more comprehensible to potential investors who had to comply with more than one of the laws. Also, proper coordination between appropriate authorities would produce better statistics. Pohnpei's decision to opt out of the proposals probably spelled failure from the beginning, but some other states have also introduced far too much variability into the stoplight system to permit much benefit from the remaining similarity. Given a history of troubled attempts at cooperation between the five governments, and especially the continuing jurisdictional disputes between the states and national Government (specifically, whether regulating foreign investment is within the constitutional authority of the states or the national Government) the goal of uniformity is probably a lost cause.

57. The third goal, making rules less restrictive, refers to eliminating or reducing various restrictions based on minimum local or maximum foreign equity, minimum local employment, minimum investment levels, minimum export requirements, intrusive application or reporting requirements, prohibition of all foreign investment in large numbers of sectors, etc. Some of these were explicit requirements and all were implicit possibilities under the prior law.

58. The fourth goal, making rules more transparent, aimed at reducing the amount of unbridled discretion afforded to the regulators. The criteria for obtaining and retaining a foreign investment permit should be clearly stated ahead of time and uniformly applied to all applicants. In most cases, a potential investor should be able to predict accurately how he or she will fare with a particular investment proposal just from reading the act and regulations.

59. While there was some small improvement in the areas of restrictiveness and transparency in the first round of foreign investment law reform in the 1990s, these goals were mostly subverted by changes that each government made to the FIAS proposals during adoption.

60. At the request of the national Government's Department of Economic Affairs, FIAS returned to the FSM and prepared a 1999 report,[10] which became known (along with its related reform attempt) as FIAS II. The second round reform proposals became the basis for the second tranche condition regarding foreign investment—namely that the FSM governments "shall have amended their foreign investment laws and/or regulations to streamline the application process and improve the consistency, transparency and fairness of the regulatory environment for foreign direct investment."

c. Status Summary

61. In assessing status, it is important to bear in mind that the FIAS scheme for foreign investment in the FSM is highly dependent upon regulations. In each government, the statute sets forth a framework for regulation, leaving much of the detail

[10] FIAS. 1999. *National and State Foreign Investment Legislation Review (FIAS II).*

to be fleshed out in regulations. Since regulations implement statutes, amendment of regulations is generally required after any significant statutory amendment, thus creating a two-step process with all its timing implications. This is in sharp contrast to the land leasing and mortgaging laws, also involved in the current consultancy, where all relevant provisions are in the proposed statutes and regulations are not necessary.

62. **National Government.** The national Government adopted its FIAS I statute in 1997 and regulations thereunder in 1999. FIAS II proposed several changes to both. Bills to amend the statute were introduced in each of the last two congresses but went nowhere. At inception of this consultancy, no bill to amend the statute had yet been introduced in the Fourteenth Congress (which commenced at the same time as this consultancy), nor had any changes to the regulations been initiated.

63. After extensive consultations with interested parties, a suitable bill, modeled after the FIAS II proposal, was introduced and passed in the September session of the FSM Congress. Public Law 14-32 was signed into law on 2 November 2005. Immediately after passage of the statutory amendments, proposed new foreign investment regulations, also modeled after the FIAS II proposal, were completed and, on 6 January 2006, these new regulations were signed into law. As a result, the national Government has complied with its condition on foreign investment reform.

64. **Chuuk State**. Although it is called the "Chuuk State Foreign Investment Act of 1998," Chuuk actually enacted its statute in response to FIAS I in 1999. State officials claim that regulations fleshing out the statute were indeed adopted, but they can produce no evidence of this. It is most likely that these were never adopted. The second report from FIAS proposed numerous changes to the statute and prompt adoption of complete regulations.

65. Assistance was provided to state officials under TA-4539 (footnote 2) to develop suitable legislation and regulations modeled after the FIAS II proposals. Preliminary contact was made with key legislators, and there was no indication of any significant opposition to the proposals. But it just seemed impossible to overcome the inertia that has come to plague Chuuk's government. As a result, Chuuk State has not complied with its condition on foreign investment reform.

66. **Kosrae State**. Along with Chuuk, Kosrae's was one of two governments that had not even adopted regulations in 2000. The second FIAS report proposed improvements to the statute and prompt adoption of complete regulations. By early 2005, no changes had been made to the statute, but regulations had been adopted in 2003. However, those regulations perpetuated the shortcomings of the earlier statute prepared based on the first FIAS report ("Kosrae State Foreign Investment Act of 1998") and changes were needed to both.

67. Thanks to extensive work with state officials—and especially with a legislature that was far more willing than most to spend substantial, meaningful time with the consultant—desirable amendments to the Kosrae act, modeled after recommendations of the second FIAS report, were passed in September and signed into law as S.L. 8-131. Progressive new regulations, also modeled on FIAS II, were published for public comment by 2 January 2006 and officially adopted on 24 April 2006. As a result, Kosrae State has complied with its condition on foreign investment reform.

68. **Pohnpei State**. Believing that foreign investment was not a proper subject for regulation by the national Government under the National Constitution, Pohnpei jumped the gun on decentralization by enacting its Foreign Investors Permit Act of 1986, several years before FIAS I came to the FSM. Amendments were made to that statute in 1999 as a result of FIAS I but without adopting the stoplight system or many other features of the FIAS approach. Existing regulations were amended in 1999 to reflect these limited legislative changes.

69. FIAS II urged a complete overhaul of the Pohnpei statute and regulations to further all the goals of FIAS I, including uniformity. Nothing had happened as of commencing TA-4539 (footnote 2). A vociferous faction of the local business community, apparently fearing competition, shows up regularly at Foreign Investment Board hearings to fight virtually every application for a new or modified foreign investment permit. As it appeared virtually certain that the complete overhaul urged by FIAS II was not going to happen, the consultant focused on working with appropriate state officials to devise and enact amendments to the existing scheme that would at least constitute a significant step in the right direction.

70. Even the watered-down approach that this consultant was prepared to approve, however, was not to be. The lobbying by these local business people led to a more regressive measure's receiving serious consideration. In this atmosphere, it is impossible even to get a progressive bill introduced into the legislature, to say nothing of any significant overhaul of the foreign investment regulations. As a result, Pohnpei State has not complied with its condition on foreign investment reform.

71. **Yap State**. Yap's FIAS I statute and regulations contained many of the same problems as exist in the other governments' efforts. FIAS II proposed changes to both and Yap responded. The statute was repealed and replaced by a new "Yap State Foreign Investment Act" in 2001 (YSL No. 5-72), to which some minor amendments were added in 2002 (YSL No. 5-99). This current statute incorporated many but not all of the changes proposed by FIAS II. Further changes to the statute were certainly desirable, but were not necessary for second tranche qualification.

72. Finally, progressive new regulations were published for public comment on 1 November 2005 and adopted on 1 January 2006. As a result, Yap State has complied with its condition on foreign investment reform.

IV. CHANGE OF A CONDITION

73. The loan documents state that funds from the second tranche will not be released to any Government unless the national Government and at least two states have met the conditions. The national Government and Kosrae State have each met the requirements. No other states have done so and are not likely to do so despite the additional time and extensive support provided. The FSM has requested that this condition be amended such that funds can be released to those governments that comply, provided that at least the national Government and one state meet the conditions.

74. The request from the FSM for the change of this condition was premised on the fact that FSM is a loose federation and the national Government has little control over the states in these areas. Considerable efforts were made by the national and Kosrae

governments to meet the conditions. This involved some political risk, so it would be appropriate that they be rewarded for their efforts. It would also be a salutary lesson for the other governments if they saw these two being rewarded for their good policy decisions.

V. CONCLUSION

75. The national, Kosrae and Yap governments have made resolute efforts to comply with the conditions for the second tranche of the Program loan. The national Government fully met all the conditions. The legislature in Yap refused to pass the required new mortgage law so, despite meeting the other conditions, it does not qualify. The activities supported by the loan provide significant value to both the national and Kosrae governments to merit proceeding with the second tranche in the absence of an eligible second state. This would ensure the continuation of improvements supportive of private sector development in the national arena and in Kosrae. It is considered that the benefits expected to accrue to Kosrae, due to the improved environment for the private sector, will have a positive demonstrative effect on the remaining three states and may encourage future reforms in these states. Furthermore, it would be good practice to reward superior performance and the political will to implement reforms.

76. The national Government and Kosrae State have made considerable efforts to comply with the conditions, and their efforts should be acknowledged.

77. **Status of Tranche Conditions.** The status of compliance with second tranche conditions of the PSDP is summarized in Table 2, with details in Appendix 3.

Table 2: Status of Compliance with Second Tranche Release Conditions

Policy and Condition	Current Status
Policy: Maintenance of balanced budgets. **Condition:** The legislative branches of the Borrower and the States shall have passed budgets for fiscal year (FY) 2003 and FY 2004 which are balanced on total current revenues and grants less current expenditures.	Condition met for all governments.
Policy: Maintenance of government payroll levels. **Condition**: The legislative branches of the Borrower and the States shall have passed wage bills with annual increases not exceeding 1.5% in FY 2003 and FY 2004 of the wage bill targets of the Borrower and the States for FY 2002 as referred to in the Development Policy Letter.	Condition met for all governments.
Policy: Sound management of the Federated States of Micronesia (FSM)	

Policy and Condition	Current Status
Trust Fund. **Condition**: The Borrower and the States shall transfer not less than 50% of the increase of budgetary support under the Compact Base Grant for FY 2002 and FY 2003 to the stability account of the FSM Trust Fund.	Condition met. (This condition only applied to the national Government.)
Policy: Sound management of external debt. **Condition:** The official external debt of the Borrower, net of assets held for loan repayment, will not exceed 24% of the Borrower's gross domestic product (GDP) in FY 2002 and FY 2003.	Condition met. (This condition was only applicable to the national Government.) The external debt, net of assets held for loan repayments, was 18% of GDP as of 30 September 2002, 17% as of 30 September 2003, 17% as of 30 September 2004, and 16% as of 30 September 2005. This is a prudent level of debt that is well within the capability of the FSM to repay.
Policy: Progress in public enterprise reform. **Condition:** Master plans for public enterprise reform shall have been submitted to each government.	Condition met for all governments.
Policy: Progress in public enterprise reform. **Condition**: The Borrower and the states shall have transformed one public enterprise each prior to the end of FY 2003.	Condition met with delay by all governments except Chuuk.
Policy: Promote the use of land and property as loan security. **Condition:** The legislative branches of the States shall have passed legislation improving the legal environment for long-term leasing of land and for encouraging mortgage-secured commercial lending.	Condition met only by Kosrae.
Policy: Improvement of foreign investment system. **Condition:** The Borrower and the States shall have amended their foreign investment laws and/or regulations to streamline the application process and improve the	Condition met for all governments except Chuuk and Pohnpei.

Policy and Condition	Current Status
consistency, transparency, and fairness of the regulatory environment for foreign direct investment.	

FY = fiscal year, FSM = Federated States of Micronesia, GDP = gross domestic product.
Source: ADB and FSM Government

VI. THE PRESIDENT'S RECOMMENDATION

78. Considering the substantial progress made by the national Government and the Kosrae State Government, the President recommends that the Board approves: (i) the change of the condition that the national Government and at least two states have fulfilled their respective conditions for the release of the second tranche to allow the release of the second tranche when the national Government and at least one state have fulfilled their respective conditions, and (ii) the release of the second tranche of the Private Sector Development Program in an amount equal to SDR0.704 million. In accordance with established procedure, the tranche release will be effective not less than 10 working days after the circulation of this progress report to the Board.

EXCERPTS FROM 1999 LAND LEASING REPORT

EXECUTIVE SUMMARY

This report contains the recommendations from a two-month consultancy ending in September of 1999. It is based on meetings with government, business, and banking leaders in all four states of the Federated States of Micronesia and with bankers in Guam.

The objectives are to make land in the FSM more readily available for development and to make financing for such development more accessible by permitting at least some of its value to be used as collateral.

The approach is to develop a system of long-term land leasing and leasehold mortgaging as an alternative to the use of freeholds, which can only be owned by citizens in the FSM. Since the ownership of leaseholds is not so restricted, such a lease-based system will allow foreign investors to have access to land for economic development projects while leaving ownership in Micronesian hands.

A lease-based system will also allow lenders, virtually all of whom have at least some noncitizen ownership, to acquire meaningful interests in land through foreclosure. As long as foreigners are precluded from bidding at a foreclosure sale, the likelihood of obtaining a fair price at that sale is greatly reduced, to the disadvantage of both the lender and the borrower. Lease-based mortgaging must be distinguished from the so-called CNMI model, whereby a foreign lender is permitted to actually own the land and, if he can, sell it for a period of time after foreclosure. While this report does favor adoption of the CNMI model, its main focus is on lending in which only a leasehold is conveyed upon foreclosure, leaving the underlying citizen ownership intact.

There are not many legal obstacles to development of a lease-based conveyancing and financing system in the FSM today. To be sure, a few such obstacles are identified, particularly in Pohnpei and Yap, and recommendations are advanced for overcoming them. Also, a revamping of existing mortgage laws is recommended for all the states in order to make them more modern and user friendly.

But for the most part, the problem seems to be lack of awareness of the possibilities and of how to achieve them fairly. If it is not done properly, long-term land leasing can be as unpalatable to owners as outright sale. Add the desire to use a leasehold as collateral for development financing and there are three parties--lessor, lessee/borrower, and lender--whose interests must be carefully balanced if investment and economic development are to be facilitated. Thus the major thrust of this report is to offer and urge adoption of the following:

- a National Policy on Long-Term Land Leasing by the FSM Congress (Appendix A);
- Model Land Leasing and Mortgage Acts by each state (Appendices B and D); and
- Model Long-Term Land Lease, Leasehold Mortgage, and Springing Lease Mortgage forms by the business and lending communities (Appendices C, D, and E).

INTRODUCTION

The Goal

The ultimate goal of this consultancy and report, as with so many others, is to facilitate economic development of the Federated States of Micronesia ("FSM"). Many changes are necessary to achieve this goal, of course, but this report focuses on making land more readily available for development and permitting at least some of its value to be tapped for development financing.

The Problem

Foreigners cannot become landowners in the FSM. The national constitution (Art. XIII, §4) states that "[a] noncitizen, or a corporation not wholly owned by citizens, may not acquire title to land or waters in Micronesia." The constitutions of two of the states further limit ownership to, in effect, the citizens of those states. *Kosrae Const*. Art. XI, §7; *Pohnpei Const*. Art. 12, §2.

Yet land is critical to many forms of economic development, as is foreign investment. If noncitizens--including entities with even the slightest amount of noncitizen ownership--cannot obtain secure land tenure of some sort, development of the private sector in the FSM will continue to be hampered.

Moreover, economic development by citizens and noncitizens alike requires capital, which usually must be borrowed. Most potential lenders, including all three commercial banks in the FSM, have at least some foreign ownership and are thus prohibited from acquiring ownership of land. This prohibition inhibits lending in the FSM because lenders require a secondary source of repayment, something above and beyond the borrower's promise to repay. Almost always this involves collateral, or some property which the borrower or his guarantor stands to lose if the loan is not repaid. Land is often the only suitable collateral.

Of course, land can be used as collateral even though the lender may be prohibited from owning it. In the event of nonpayment, the property is sold through a controlled procedure called foreclosure, and the price obtained at the sale is applied against the loan. If the sale price exceeds what is due on the loan, the borrower gets the excess. If the sale price is not enough to repay the loan, the borrower still owes the shortfall, but this "deficiency", as it is called, can be very hard to collect once the collateral has been exhausted. Thus a high sale price is beneficial to both the borrower and the lender. The lender has greater assurance of repayment in full, and the borrower has greater assurance that he will not continue to owe money and may even receive some excess sale proceeds.

A high sale price requires the broadest possible universe of potential buyers. If that universe is limited to citizens, because only they can acquire title to land, the likelihood of getting top dollar at a foreclosure sale is greatly reduced. Moreover, persons interested in buying the property may not be able to come up with the cash quickly enough to do so at a foreclosure sale, or they want more time to consider the purchase, or the property needs some repair before it will sell well.

For these reasons, the lender will almost always be the highest bidder at a foreclosure sale if he is legally permitted to acquire the interest which is being sold. The lender does not want to own the land--that is not his line of business--but neither does he want the land to be sold for too little. The typical lender bid at a foreclosure sale (called a "credit bid" because the lender pays with debt reduction instead of cash) is the lesser of what he is owed or what he thinks the property is worth. Usually this will be the highest bid and the lender will take over the property, fix it up, and market it in a more orderly fashion than is possible in a foreclosure. Even then, his ability to sell the property for a good price will depend on whether the lender is free to sell to anyone or only to citizens.

Collateral is worth much more to a lender when anyone, including and in particular the lender himself, can acquire the property given as collateral. Right now that is impossible in the FSM with respect to ownership of land and problematic with respect to leaseholds, the major alternative to ownership. The result is that lending and development are inhibited.

The Solution

One solution would be to repeal the constitutional prohibitions on noncitizen ownership of land. This is very unpopular and unlikely to happen anytime soon. Even the more limited reform of adopting the so-called "CNMI model"--whereby a noncitizen lender could take title to land in a foreclosure and thereafter hold it for a limited period (such as 10 years) before having to sell it to a citizen--requires difficult constitutional amendments in Kosrae, Pohnpei, and at the national level.

This report joins prior reports in urging adoption of the CNMI model. Once it is adopted, however, it will not be a panacea. It will complement, but not eliminate the need for, an alternative solution. Noncitizens will still need access to land for development quite apart from their financing needs, and some landowners will still be unwilling to put their entire ownership interest at risk in exchange for financing. These concerns require an alternative.

The alternative solution is to develop a system of long-term leaseholds and leasehold mortgages. A leasehold is the interest of the tenant (lessee) under a lease, and a leasehold mortgage is the collateral in a leasehold. Instead of selling his land, the citizen owner leases it to a person who wishes to develop it. That person, the lessee, may be either a citizen or a noncitizen, although it is most likely to be the latter. When the prospective developer is another citizen, he would probably prefer to buy the land.

The developer, in turn, mortgages--that is, gives a collateral or security interest in--his leasehold interest in the land. If he fails to repay the loan and there is a foreclosure, it is the leasehold interest, not the freehold (ownership) interest, which is sold at the foreclosure sale.

Where the developer is himself a citizen who owns the land to be developed, he may choose to mortgage either the freehold interest or a leasehold interest. The leasehold interest is created by a "springing lease" which is secured under a "springing lease mortgage." The springing lease is negotiated at the beginning of the loan but does

not go into effect unless and until there is a foreclosure. Upon foreclosure, the lease springs into effect and the purchaser at the foreclosure sale gets a leasehold rather than a freehold interest. This permits the landowner to tap some (though not all) of the value in his land for financing purposes without risking loss of ownership.

Variations under a springing lease mortgage include offering both the freehold and the leasehold for sale simultaneously, then selling whichever one draws the higher bid. The freehold may draw the higher bid because it is a fuller interest in the land, or the leasehold may draw the higher bid because both citizens and noncitizens are permitted to bid on it. The more the owner is willing to put at risk, and the more potential purchasers there are at a foreclosure sale or thereafter, the more likely it is that a lender will be willing to lend.

Thus a leasehold system provides a means for opening up the land system to better serve the twin objectives of making land more readily available for development and permitting some of its value to be tapped for financing, while at the same time avoiding the possibility that the borrower could actually lose ownership of his land. Such a system is the focus of this report, but first we must acknowledge the existence of other barriers to the achievement of our objectives.

Other Problems and Solutions

Prior consultancies and conferences have identified a wide range of barriers to opening up the land system. These include problems in the areas of land surveying, title registration, determination of disputed titles, title insurance, valuation, regulation of land uses, and inconsistencies between statutory and traditional systems of ownership and conveyancing. Many believe that the courts, especially at the state level, are biased in favor of squatters as against owners, citizens as against noncitizens, debtors as against creditors. Traditional reverence towards the land and cultural aversion to confrontation combine to make it almost impossible to dispossess a Micronesian of his land.

The system proposed in this report will not solve all of these problems. Some of them will require further assistance from abroad. Others will only be overcome gradually over time, as attitudes change from generation to generation. All must be substantially resolved before land can play as full a role in developing the economy here as it does in many other countries.

But one must start somewhere, and each reform will both suffice to open up land in some specific cases and facilitate further reform in general. Miracles do not happen overnight, but take one positive step at a time and positive change will gradually appear. It is hoped that the system proposed herein will be seen as one such positive step.

LONG-TERM LAND LEASES

Definitions

A land lease, sometimes also called a ground lease, is any lease of improved or unimproved land for any purpose--residential, agricultural, industrial, commercial, etc. It is to be distinguished from a premises lease, which primarily covers space within a

building, such as an apartment or office suite. While a premises lease generally has a fairly short term, a land lease can have a term of almost any length.

There is no fixed point at which a term becomes a long term. For purposes of this report and the proposed lease law, a somewhat arbitrary cutoff point of 20 years has been selected. A long-term land lease is thus any land lease with a term of at least 20 years.

The concept of "term" requires further consideration. A lease always has an initial fixed term, often accompanied by one or more options to renew or extend that initial term. (Technically, a renewal is a new lease and an extension is a lengthening of the original lease, but over time "renewal option" has come to have the same meaning as "extension option" for most people. Since the words are practically interchangeable now, and since the effect of either a true renewal or a true extension is the same for our purposes, the more correct "extension" will be used to refer to either a renewal or an extension option or to the term which results from the exercise of such an option.)

Should extension terms be counted when determining whether a lease is a "long-term" lease? Yes, if the exercise of the option to extend is entirely within the lessee's control. No, if the landowner must agree to the extension or to some provision (such as renegotiated rent) applicable during the extension. The former is a true option, and the key difference is how long the lessee can hold on to the land, if he wants to and complies with his obligations, even though the landowner may want the land back. As we shall see, this concept is important when it comes to applying statutory or constitutional term limitations to a specific situation.

Length of Lease Terms

For certain kinds of development--for example, a major resort hotel complex--it may take a long time to recover the huge investment involved, together with a return on that investment which is sufficiently large to induce the initial risk taking. Acquiring secure land tenure, financing, and development permits may take years. Construction will add more years, during which interest is accumulating and no offsetting revenues are coming in. Once completed, the project may operate in the red for some time while it builds up a clientele. Often the big profits--the ones that made the project attractive in the first place--do not start appearing until many years down the line. Of course, some projects "turn the corner" more quickly than others. But nobody invests huge sums on the assumption that everything will go perfectly--especially not in markets, like the FSM, which are still relatively remote and untested.

Nor does this calculus change if we assume that the original developer, as is often the case, will sell out soon after the project is completed or profitability is achieved. The amount of time remaining on the lease term at the time of sale will directly affect the sale price. A buyer will pay less for a project that he can operate for only 10 more years than for one with 50 years left on the term. The estimated sell-out value will, in turn, affect the willingness of the original developer to undertake the project in the first place.

In short, the longer the term, the more valuable the leasehold and the more likely it is that the numbers will work out in favor of investment. In many places, a term of 99 years has been common in the past. There is nothing magical about this number.

Certainly it represents the maximum term that anyone could reasonably need, and lesser terms will suffice in most instances. Still, if we are designing the ideal system, we should allow for those few cases, often disproportionately important from a development perspective, which truly do need a very long term.

Existing laws do not always allow this. In two of the states (Chuuk and Kosrae), there are no legal limitations on lease terms. However, Yap's constitution prohibits any lease ("agreement for the use of land") to a noncitizen of the FSM for more than 50 years (Art. XIII, §2). It is recommended that Yap amend its constitution to repeal this provision or change the 50 years to 99 years.

Pohnpei's constitution prohibits leases, except from the government, for more than 25 years but authorizes the legislature to permit longer terms (Art. 12, §§1 and 4). The legislature has done this in the Development Leasehold Act of 1996 (S.L. No. 4L-21-96), which allows up to 55 years if various requirements are met. As discussed in the next section, the Act assumes a leasing model which this report rejects. It is recommended that Pohnpei enact the Model Leasing Law included in this report, if not as a replacement for, then at least as an alternative to, the Development Leasehold Act.

The national constitution prohibits leases to noncitizens of the FSM for an "indefinite term" (Art. XIII, §5). This clause was amended into the constitution in the early 1990's and has never been tested in the courts. Debate at the time suggests that the intent was to ban leases with unlimited or unstated terms, not those with what might be deemed excessive terms. Almost certainly, a lease with a term which is definite, no matter how long, will not violate this clause. But is a term "definite" if it consists of an initial term and one or more optional extensions which may or may not ever be exercised? Surely it is; otherwise a common and useful commercial practice, applicable to both land and premises leases of any length, would be inadvertently banned.

In short, the "indefinite lease term" clause of the national constitution probably does not bar leases of up to 99 years, including extension options. However, just to be safe (or at least safer), the proposed National Policy on Long-Term Land Leasing includes a declaration by Congress to that effect. Courts typically defer to explicit legislative interpretations of unclear constitutional provisions.

Two Models for Landowner Protection

More than anything else, what a landowner expects from a land lease is a fair rent. While there are many variations in between, it is useful to consider two polar models of how rent can be paid. In the lump sum model, all the rent is paid in one large payment at the beginning of the lease term. In the periodic payment model, rent is paid--and adjusted to reflect inflation and market changes--throughout the term.

The lump sum model is popular with some foreign developers, particularly those familiar with practices in CNMI, because it fixes their land costs for the entire term. Since land almost always increases in value over a long enough time, the rent negotiated at the beginning will eventually come to be seen as a bargain for the lessee/developer. The landowner rarely looks that far into the future and is attracted instead by the prospect of a single large payment immediately. Why get many small payments over a long time when you can get one really big one now?

Years latter, however, the lump sum payment is spent. The owner sees land values all around him rising and a successful project on his own land. He realizes that he “sold cheap” and thinks that, as the owner of the land, he is entitled to more. His heirs are even more prone to such thoughts. They look for ways to break or renegotiate the lease. A lawyer tells them that a lump sum lease with a long enough term is tantamount to a sale of the land, and since the foreign lessee could not have bought the land outright, a court may be willing to invalidate a lease that accomplished essentially the same end. They sue, lose, and feel cheated. Or they sue, win, and the lessee feels cheated. Neither outcome is desirable.

The periodic payment model avoids this. By spreading rent payments throughout the lease term, it keeps the present owner from denying his heirs the benefits of their inheritance. By adjusting for land value increases, it insures that the current owner of the land, at any point in time, is receiving a fair rent. Of course it is less attractive to the lessee who seeks a bargain, and the uncertainties of how much the rent will increase in the future create legitimate concerns for the lessee and his lender alike. These concerns, together with our inability to adjust rent perfectly and the impracticality of trying to do so too often, require some retreat from the ideal form of the model. But even in imperfect form, the periodic payment model is far better for the landowner and no worse for many lessees than the lump sum model.

If we assume that the landowner is receiving a fair rent, that his land is not being abused, that he or his successors will get the land back someday, possibly with improvements of considerable value still on it, then the major legitimate concerns of the landowner have been met. He does not need to have final say on everything that the lessee does with the land. He does not need to exact some of the gains when the lessee assigns the lease and sells his project. He does not need to submit his lease for government review before it becomes effective. He does not need to insist upon new construction of a certain value. He does not need a whole panoply of protections designed to compensate for a fundamentally unfair deal because the deal will not be fundamentally unfair.

This is the problem with the Pohnpei Development Leasehold Act, which is premised on the lump sum model. The problem is not that it attempts to protect the Micronesian landowner--any acceptable system must do that--but that it does so by addressing peripheral instead of core concerns. And it does so in a way that makes the whole process too objectionable to lessees. That is why virtually all advisors who have looked at it favor repeal of the Act.

But even if the lump sum model is acceptable, surely the periodic rent model, without all the peripheral protections, should be a permitted alternative. Pohnpei could adopt the system advocated in this report without repealing the Development Leasehold Act and let lessees and landowners chose which approach better suits their needs.

Paying and Adjusting Rent

If the periodic payment model is the best guaranty of fairness to the Micronesian landowner, its implementation must be partly through legislation and partly through education. Legislation must strike an appropriate balance between protectionism and

recognition of the variety of situations which may call for an exception to the general rule. Education must then assure that landowners understand the importance of following the general rule whenever possible.

For example, the Model State Land Leasing Act (Appendix B) allows advance payment of rent by up to 10 years. Except perhaps at the very beginning of a lease term, and then only for perhaps 5 years, this is not ideal. But it is felt to be appropriate in order to avoid excessive interference with the freedom to contract. While one cannot go too far wrong by paying only 10 years in advance, one year is preferable as a general rule. Thus the Model Long-Term Land Lease (Appendix C) provides for annual payments of rent. Landowners need to be educated to go with the provisions of the Model Lease rather than the more permissive ones of the Model Act unless there is a good reason for not doing so.

Another example involves the frequency of adjusting rent. Adjustments should be frequently enough to keep fair market rent from diverging significantly from actual rent. On the other hand, the process of adjustment entails disruption and costs which make it undesirable to resort to the process too often. Experience has shown, and prior advisors have recommended, that 10 years is an appropriate interval between rent adjustments. Yet the Model Act would permit 25 years to elapse before the first rent adjustment under a new lease.

The reason is that lenders will generally not loan against a leasehold for a term longer than the period during which rent payments are predictable in amount. Rent can escalate during that period, but it must do so in predetermined increments. The possibility of an unexpectedly high increase can affect the borrower's ability to repay the loan and thus the lender's willingness to make the loan in the first place. Since one of our goals is to facilitate leasehold mortgaging, we must be careful not to permit rent adjustments from getting in the way.

It appears that, for the foreseeable future, 25 years is about the longest term that will be available on a leasehold mortgage in the FSM. A land lease for development purposes is most likely to need leasehold financing at the beginning of its term, so the Model Act permits, at the beginning of the term only, a 25 year exception to the general rule that rent is to be adjusted every 10 years. But in situations where a long-term leasehold mortgage is not anticipated, landowners should be educated to insist upon adherence to the 10 year rule from the beginning.

The methods for adjusting rent, if the parties cannot agree to an adjustment on their own, are too complicated and variable to be spelled out in legislation. Thus the Model Act merely requires that the lessor and lessee provided for their own chosen method in the lease. The Model Lease, in turn, contains alternate suggestions under both of the two general approaches.

One approach is by reference to a standard, such as the consumer price index (CPI). This is simple, but it may approximate land value changes in only the roughest of ways.

The other approach is appraisal, in which case an appraisal mechanism must be specified. The Model Lease suggests a mechanism that does not require professional appraisers (since there presently are none in the FSM) and gives each party an

incentive to appoint a fair-minded person to represent him in the appraisal process (since the more biased of the representatives is likely to have his opinion disregarded in the final determination). Over time, data on which to base determinations of fair market rental value should become more available in the FSM, as will persons with some specialized knowledge of appraising. And a large enough project will justify bringing in experts from Guam or elsewhere outside the FSM.

The standard for appraisal must be the fair market rental value of the land without any improvements except for those which were there at the outset of the lease and are still there at the time of appraisal. The land value properly belongs to the landowner, but the value of the improvements he has made and the business(es) he operates on the land belong to the lessee. If they are taken into account in fixing his rent, the lessee will end up paying for them twice--once when he built them, and then again over time through higher rent payments.

A way of benefiting the landowner between rent adjustments is to structure the rent as a minimum base rent plus a percentage of the gross or net income that the lessee derives from the property. The minimum will be adjusted periodically, probably by reference to something like the CPI rather than appraisal, while the percentage allows the landowner to share in the success (if any) of the lessee. This can increase the owner's rental return while gaining his support for a business which he might otherwise resent, but it is not always suitable and is thus inappropriate for inclusion in the Model Act. Landowners should be educated to think of percentage rent whenever appropriate, however.

The Model Lease includes an optional percentage rent clause for consideration. It is based on the lessee's gross income. Net income can be very difficult to define and monitor, and the unsophisticated landowner may find that net income is consistently too low for his percentage to kick in. Unless they have good legal and accounting representation in negotiating the percentage lease clause, landowners are better off insisting on gross income as the base for any percentage rent.

A long-term land lease can take many forms, depending on the purpose of the lease, its term, the need for new construction, the need for mortgage financing, the relationship between the lessor and lessee, and many other factors. No piece of legislation and no single lease form can adequately provide for all the legitimate possibilities. The challenge is to close as few doors as possible while maintaining a core of minimum requirements to prevent the worst abuses. It is believed that the Model Act and Model Lease attached to this report strike the right balance in this regard.

MORTGAGES

Introduction

Inducing lenders to lend against real property is partly a matter of assuring that there is a large group of permissible buyers--including the lenders themselves--should a foreclosure ever become necessary. But it is also a matter of assuring that a foreclosure can occur at all. As this report is being written, it appears that there has never been a successfully completed foreclosure anywhere in the FSM. A few are in progress right now, and there has been at least one successful (though unopposed) execution on land

to satisfy an unrelated judgment. But the picture is clear: lenders are justifiably concerned that when push comes to shove, they will be denied the benefits of their security.

Discussions with bankers in the FSM and Guam revealed a remarkably consistent fear of going to court in the FSM. The courts are seen as slow, relatively unknowledgable in creditors' rights, and inclined to favor Micronesians over foreigners, individuals over corporations, and debtors over creditors. The single most useful reform would be to permit nonjudicial foreclosure, as is already the case in Guam, Hawaii, and many other places. Also very useful is reduction of the lengthy statutory periods before a foreclosure sale can be held and any redemption rights lapse, removal of the arbitrary limit on attorneys' fee recovery, and simplification of notification procedures.

These and similar changes are attractive to lenders regardless of whether the mortgage encumbers a freehold or just a leasehold. The Model State Mortgage Act makes these changes in a way which leaves the landowner with more protections than the states now give him under their own deed of trust laws. The Model Act also contains provisions of special relevance to leasehold and springing lease mortgages. Before looking at the Model Act, however, we should take stock of what is already on the books.

Existing Laws

All four states have a deed of trust statute, and all but Kosrae have a mortgage statute. What is the difference? Both are ways of borrowing against real property, but the mortgage involves two parties and the deed of trust involves three. Under a mortgage, the owner ("mortgagor") transfers an interest in the subject property to the lender ("mortgagee") to secure repayment of the loan. Under a deed of trust, the owner ("trustor") transfers an interest in the subject property to a third party (the "trustee") for the benefit of the lender ("beneficiary").

Depending on the time and place, the interest transferred under either instrument might have been actual title to the property or only a lien upon that title, but deeds of trust tended to the former and mortgages tended to the latter. Nowadays, however, both instruments are usually viewed as creating only a lien, and such is the case under all of the FSM mortgage and deed of trust statutes.

Another common (though not universal) distinction has been more durable and does apply to the FSM state statutes: the trustee under a deed of trust has the power to sell the property in foreclosure (a "power of sale") without going to court, while a mortgagee may only foreclose through a court action. Since the former is more expedited and less vulnerable to judicial bias, it is preferred by lenders. In many other ways as well, the FSM deed of trust statutes are more lender oriented than the mortgage statutes.

There is a reason for this. The FSM state deed of trust statutes were designed to accommodate U.S. Rural Development (formerly known as Farmers Home Administration). In each case, the trustee is a state governmental official entity which, in the event of a default and foreclosure, is required to pay Rural Development the difference between the amount due on the loan and the amount obtained at the

foreclosure sale. In effect, the public is guarantying repayment of the deficiency. The government shares the lender's interest in facilitating foreclosure.

In fact, the situation is worse than it appears from the statutes alone. Memoranda of understanding between Rural Development and the states call for the trustee to make good on its guaranty even before foreclosure by paying Rural Development the entire amount due and accepting an assignment of the note and deed of trust. The trustee may then attempt to recover its loss by foreclosing on the property, but it is unlikely to do so: a state government would find it politically difficult to take land away from one of its own citizens.

Thus, the state government is guarantying the whole of the amount due. The state also has a statute which is at odds with its contractual commitment to Rural Development. If push comes to shove, which would control? The states would be well advised to resolve this situation promptly. Kosrae and Yap, which do not limit who can be beneficiary, should also look carefully at whether a lender whose loans the state does not wish to guaranty can utilize the deed of trust without the state even knowing it. Most likely, amendment of the existing deed of trust statutes will be needed to limit their application to Rural Development loans and conform them to Rural Development's expectations. Such amendments are beyond the scope of this consultancy.

Because of these problems, it was decided not to use the existing deed of trust statutes as the basis for reform. And if the choice is one between a new deed of trust law which requires a third party trustee and a new mortgage law which does not, the latter is preferable. Not only is it simpler, but it also avoids leaving the control of foreclosures in the hands of a government official who may have no idea of what to do and personal qualms about doing it.

The three existing state mortgage laws, like the deed of trust laws, all appear to have derived from the same original proposed law. They contain many good provisions which lenders, lawyers, and other concerned parties are already familiar. While this counsels revising rather than replacing the existing laws, the desired changes are so extensive, dispersed throughout the statute, and variable from state to state, that a single set of model amendments was felt to be impractical. Thus the decision was made to propose an entire new mortgage statute, but one which is based on the existing ones. It is recommended that the states enact the Model State Mortgage Act (Appendix D) and repeal their existing mortgage statutes.

A word about Kosrae is in order here. Instead of a mortgage statute, Kosrae tried to do it all in their deed of trust statute. Where the other states' deed of trust statutes end, Kosrae's goes on to add provisions for judicial foreclosure and redemption rights as an alternative to the power of sale. The result is confusing. Among other things, it is often unclear whether certain rights or duties belong to the trustee or the beneficiary. Moreover, the deed of trust statute cannot function properly as a foreclosure law of general application as long as it remains oriented to the special needs of Rural Development. Kosrae would benefit perhaps even more that the other states from enacting the Model State Mortgage Act. And repealing the confusing language on judicial foreclosure contained in the deed of trust statute (§§11.412 through 11.415) would simplify that law.

Model State Mortgage Act

The Model State Mortgage Act is based on the existing mortgage laws in Pohnpei, Chuuk, and Yap. It incorporates what is felt to be the best of each state's variations, while removing or toning down overly protective provisions most likely to hinder mortgage lending. The major changes are as follows:

1. Nonjudicial foreclosure is added as an option for certain lenders when they foreclose on a leasehold interest. The same notices, publications, postings, waiting periods, etc. apply as in a judicial foreclosure, and the mortgagor can seek court protection if he believes the foreclosure is not being done right. But for the lender who is willing to play by rules assuring fairness to the mortgagor, many of the frustrating delays and obstacles to foreclosure under existing law can be avoided.

Eventually, nonjudicial foreclosure should be available regardless of whether the foreclosure is on a leasehold or freehold interest. This is not felt to be acceptable at present, however, because the fear of losing title to land remains so high. Loss of a leasehold, on the other hand, is less wrenching, does not disturb the underlying ownership, and will often involve a noncitizen mortgagor. Thus leaseholds are an ideal place to start with new provisions.

2. Redemption periods are shortened in all cases and eliminated entirely when the interest sold is a leasehold. The right of redemption occurs after a foreclosure sale. The owner of the land just before the sale has the right to buy the land back for the amount paid at the sale. This redemption right is rarely exercised: if the mortgagor could not find the funds to cure his default shortly before the foreclosure, he is unlikely to find the funds (often greater in amount) necessary to redeem the property shortly after foreclosure. Nevertheless, the mere possibility of a redemption prevents the purchaser at the foreclosure sale from making any significant expenditures on the property or selling it to someone else. As a practical matter, the property is frozen during the period in which a redemption is possible.

For reasons similar to those discussed in connection with nonjudicial foreclosure, leaseholds are a good place to start in resolving this problem. Where a leasehold is sold at foreclosure, the right of redemption is eliminated. Where a freehold interest is sold, the right of redemption is retained but shortened to 6 months. Presently, it is one year in Kosrae and Pohnpei, while Chuuk and Yap have no redemption right at all. (Yap, however, gives the mortgagor the excessively long period of up to one year in which to cure the default before foreclosure. The Model Act reduces this to the more reasonable period of 3 months already found in the other states.)

3. Recovery of attorneys' fees is made easier. All but Kosrae presently put a dollar limit on how much can be recovered, but a lender should be able to recover all his fees resulting from a mortgagor's default, so long as they are reasonable in the circumstances. The lender will have to pay his attorney, no matter what, and to the extent that he cannot charge it to the defaulting mortgagor, it becomes just another cost of doing business which must be recovered through higher interest rates. Since all borrowers must pay more, the good ones end up subsidizing the bad ones. This is unfair and weakens the incentive to avoid defaults.

4. Springing leases and mortgages thereon are expressly authorized and regulated. Present laws make no mention of springing leases. A few local lawyers have put them in their security documents but never actually had to invoke them. These documents may not be enforceable because existing law (like section 5 of the Model Act) often provides that any transfer of an interest in real property made for security purposes is governed by the mortgage law, that law requires foreclosure to realize upon the security, and the existing springing lease arrangements circumvent foreclosure procedures.

The Model Act resolves this by providing for the enforceability of springing lease mortgages, while protecting the mortgagor by requiring that foreclosure procedures be utilized. It also establishes rules for handling a foreclosure where both a springing lease and the entire freehold interest have been mortgaged. Whether to mortgage just a springing lease or to include the freehold as well is up to the mortgagor at the time the loan is made. As noted elsewhere in this report, the loan amount and terms that a lender is willing to offer will depend on the value of the collateral, and a freehold may be worth more than a springing lease.

The Model Act provision on springing leases (§23) refers to a conveyance in lieu of foreclosure. Such a conveyance is used where the mortgagor is willing to forego the protections of a formal foreclosure in order to avoid delay and expense and thus reduce the amount of interest and costs that are added to the indebtedness. Often it will include other benefits to the mortgagor, such as waiver of a deficiency judgment. It must be negotiated at the time of default, and an agreement in advance to convey in lieu of foreclosure (such as in the original mortgage) will not be enforceable against the mortgagor.

5. Foreclosure sale procedures are specified in the Model Act. Existing laws refer the reader to other laws governing sales under executions generally. These laws are often ill-suited to sales of real property. They are confusing and even circular: in at least one state, the executions statute says that when it comes to real property, the rules applicable to mortgages shall apply. Pohnpei State Judiciary Act of 1999, §11-26. Clarity of the law and uniformity among the states are better served by specifying mortgage foreclosure sale procedures in the mortgage law.

6. Notices to the mortgagor are simplified. The present process for notifying the mortgagor of defaults and other matters is too cumbersome. No notice is deemed given until actually received. If the mortgagor cannot be found, an effort must be made to serve a personal representative whom the mortgagor should have (but in many cases will not have) identified in the mortgage. If this too fails, the notice must be filed with the clerk of courts, posted in the municipality where the land is located, and (in some states) announced on the radio and published in a newspaper for 4 weeks. Thus a mortgagor who chooses to make himself unavailable can substantially delay the process and increase its costs at several points in the process. The mortgagor is required to keep the lender notified as to his current address at all times. He should not be rewarded for failing to do so.

Thus §13 of the Model Act provides for a more commercially reasonable system of notifying the mortgagor. Note, however, that where it is important for other people also to receive notice, the additional mailings, recordings, postings, and radio

announcements may also come to the attention of the mortgagor. And when a judicial foreclosure is commenced, the normal rules for service of process will apply.

7. The Model Act clarifies provisions on the right to possession after default, recording, and numerous other matters. Court jurisdiction is no longer limited to state courts where a national court would have jurisdiction under the national constitution. Newspaper publications are dispensed with because there are no newspapers of general circulation in the states, nor has there ever been one published with sufficient frequency (at least once a week) to meet the requirements of existing statutes. If radio announcements and postings on the property and in the municipality are not enough, a state may wish to consider adding television announcements.

COMMENTS ON THE EXISTING CHUUK STATE LAND LEASING AND LEASE-BASED MORTGAGE ACT

A. Introduction

1. Reference is made to the Model State Land Leasing Act and the Model State Mortgage Act (the "Model Acts") contained in an earlier report (referred to here as the "Leasing & Mortgaging Report").[11]

2. The Chuuk State Land Leasing and Lease-Based Mortgage Act, CSL No. 6-03-18, Act No. 6-33 (the "Existing Act"), was clearly enacted in response to the recommendations of the Leasing & Mortgaging Report but with variations that significantly reduce its potential for having positive impact on private sector development.

3. The purpose of these comments is to highlight some shortcomings of the Existing Act and propose its repeal and replacement by two new acts more in line with the original Model Acts.

B. General Comments

4. The Existing Act combines both Model Acts into one law and makes the new mortgage provisions applicable only to leasehold mortgages. The existing Chuuk mortgage law remains in place (and unimproved) for all other purposes, thus reducing the benefits to be gained from complete replacement of that existing law. Also, when the Chuuk code is finally created, leasing and mortgaging will probably fit better into separate chapters rather than to be forced together as one.

5. The Existing Act drops the concept of springing leases. This makes no difference to foreign developers, who must obtain leases from the outset anyway, since they are prohibited from owning land. But it greatly reduces the potential value of the system to domestic developers who already own the land they wish to develop. Commercial banks will still balk at taking a mortgage from such an owner because of their inability to sell the collateral to themselves or other foreigners at or after a foreclosure sale.

6. The Existing Act and the Model Acts each require leases, leasehold mortgages, and related documents to be recorded, but, unlike the Model Acts, the Existing Act says they are void unless recorded. (The Model Acts just say that failure to record risks loss of priority pursuant to the general recording law.) This is a tough rule which can lead to unfair outcomes, especially with regard to related documents (such as assignments, amendments, extensions, rent adjustments, terminations, etc.) and short-term land leases. It is also at odds with the rest of the state law on recording, and it thus adds complexity and potential for conflicts when both laws must be applied to decide a single dispute. (This issue arises in sections 6(2), 9, and 21.)

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[11] ADB. 1999. *Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging*. Manila (TA 2758).

7. The Existing Act deletes any right of redemption. That is okay so long as the act relates only to leasehold mortgages, but it may be desirable to reinstate a right of redemption with respect to freehold mortgages, as suggested in the Model Act, if, as strongly recommended, the act is replaced by something more like the Model Act, which would cover all types of mortgaging.

8. The Existing Act contains numerous spelling and formatting errors, some of which may produce significant ambiguity.

C. Section-by-Section Comments (Leasing)

(i) **Section 3**. Defining "standard land lease" as a type of lease separate from a "long-term land lease" is unnecessary and leads to confusion and some awkward usage elsewhere in the Existing Act. The Model Act simply makes a "long-term land lease" a subset of "land lease," which is simpler and less confusing.

(ii) **Section 6(1)**. The last two sentences are unnecessary. The first of those two is also confusing, since the 10 year period at the beginning of the lease term might in fact be 25 years pursuant to the first sentence of this section.

(iii) **Section 8(1)**. The Model Act refers here to a "land lease or memorandum thereof," which permits use of a common and useful short form that puts key lease data on the public record while permitting the parties to hold back potentially confidential detail and the recording process to be simplified. Unfortunately, the Existing Act eliminates the reference to such a memorandum. The only things that really need to be recorded are things that the parties to a transaction want the rest of the world to have notice of, not every little detail.

(iv) **Section 8(3)**. Requiring acknowledgement to be before a Chuukese or Federated States of Micronesia (FSM) Supreme Court judge is far too restrictive, especially for parties residing elsewhere—for example, a landowner living in Fiji or the US. The Model Act permits the use of other appropriate officials, as well.

(v) **Section 10**. This is an entirely new section compared to the Model Act. What it attempts to accomplish—a kind of quieting of title in the lessor and thus his or her new lessee—is admirable but very incomplete. It requires either i) extensive elaboration regarding the solicitation and filing of adverse claims, the procedures for hearing and deciding them, rights of appeal, and the effect of a final determination, or ii) its removal from this act. The latter is recommended, since the matter of formally determining or quieting land titles is best left to another law of general application. Such a law, in fact, may itself be amended as part of the ongoing land registration component of the private sector development project.

(vi) **Section 11**. This section of the Existing Act is full of problems. First, the free transferability by lessee in subsection (1) and by lessor in subsection (2) should be subject to variation by agreement of the parties as provided

in the Model Act. Second, the reference to subsection (4) in those first two subsections should be eliminated because the notice required from a transferring lessor does not affect the ability of the transfer, just its ability to bind a lessee before he or she has been notified of it. Third, the reference to subsection (5)—and subsection (5) itself—should be eliminated because it is too tough and likely to cause problems. (For example, it is unclear whether there even is such a thing as a "Notarized Certificate of Mailing from the FSM post office"). The notice provisions elsewhere in the act and in the general land recording law are sufficient.

(vii) **Section 12**. The clause "including consent by joint resolution from the State Legislature" should be eliminated. It is either redundant as a law "generally applicable to the leasing of public land" or it should be made so. Also, if and when that generally applicable law is ever amended, it should not be necessary that someone remembers this law also needs to be amended.

D. Section-by-Section Comments (Mortgaging)

(i) **Section 14**. The Existing Act added a sentence limiting ownership of land to FSM citizens. This is unnecessary because the FSM Constitution already so provides. It is also out of place in this section, which is about rights of possession and not of ownership.

(ii) **Section 18**. "Except as otherwise provided by statute" has been deleted from the beginning of the first sentence. The effect is to prevent use of the Chuuk State Deed of Trust Act (used by Rural Development to make home loans in Chuuk) where the Existing Act applies. This is bound to create unnecessary problems with Rural Development financing of new homes or home improvements.

(iii) **Section 20(1)**.Lease terms (as opposed to just identification of the lease and affected land) should not have to be included in a leasehold mortgage. This results in over-recording, disclosure of potentially confidential deal terms, and a need to amend the mortgage (and record that amendment) every time the lease is amended (and recorded). The simpler requirements of the Model Act are sufficient.

(iv) **Section 20(3)**.Same comment as under section 8(3) above.

(v) **Section 22**. Deletions from the Model Act in this section of the Existing Act inexplicably deny other encumbrancers the benefit of this provision.

(vi) **Section 23**. Mere changes of address in subsection (1) or representative in subsection (2) should not have to be recorded, and parties to a mortgage should not have to consult the records before sending notices to each other. This should be dealt with in the mortgage itself as between the parties to that mortgage.

(vii) **Section 29**. Consensual waivers with respect to a particular default should be permitted after that default has occurred. Otherwise, tools

which are useful to both parties, such as the conveyance in lieu of foreclosure, will be prohibited.

(viii) **Section 35(2)**.It is the property actually subject to the mortgage and to foreclosure (“a leasehold interest in Blackacre” and not just Blackacre itself) that must be legally described. The problem here also affects sections 34(2)(a) and 37(2)(a) and is resolved by using the language of the Model Act.

(ix) **Section 49(1)**.Requiring full compliance with the Existing Act (as opposed to substantial compliance, which is otherwise implied) can result in harsh consequences for a minor technical error, and it thus reduces the attractiveness of the act to lessees and lenders.

POLICY MATRIX

The actions listed in the Policy Matrix must be fulfilled to the satisfaction of ADB as conditions for Board consideration (first tranche release) and second tranche release. The two tranches will be released to the national Government in two steps, if necessary, the first tranche being released when the national Government and at least two of the states meet the targets set out in the policy matrix. For the state(s) not meeting the targets, the corresponding amount will be withheld. Subsequently, additional releases could be made as the concerned state(s) achieve their targets, provided that these are met by a revised deadline, as agreed. If a state fails to meet its targets, then these portions of the loan will be canceled.

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
Section 1:		**Maintain Economic and Public Sector Reforms**			
All	1a	Maintain balanced budgets	Balanced budget for FY2002 on total current revenues and grants less current expenditures for national and participating state governments (completion date: October 2001)	Continued implementa-tion in FY2003 and 2004	All governments have passed balanced budgets in the fiscal years concerned. There are legislative or constitutional requirements for this in each government. The Joint Economic Management Committee will oversee the budgetary process in the future.
All	1b	Maintain govern-ment	Wage bill of the national and each participating state	Continued maintenance of wage bill	**General:** There are no available figures for actual wages in 2004, although figures for 2003 and indicative 2005 figures do exist.

Govern-ment	Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
	payroll levels and reduce public to private sector wage different-tials	government in FY2002 will be passed by the respective legislative branch with amounts not exceeding: National: $8.41 million Kosrae: $5.80 million Pohnpei: $12.90 million Chuuk: $15.94 million Yap: $4.51 million. (completion date: October 2001)	restraint with annual increases not exceeding 1.5% in FY2003 and 2004	**National:** The implied targets were $8.410 million in FY2002, $8.536 in FY2003, and $8.664 in FY2004. The actual wage bill was $8.117 million in FY2003 and is estimated at $8.348 million in FY2005, lower than the implied target for 2004. Condition met. **Chuuk:** The implied targets were $15.94 million in FY2002, $16.179 in FY2003, and $16.421 in FY2004. The wage targets have generally been met. There was a period in 2003 when they climbed to $16.75 million on an annualized basis, but then they decreased, and by FY2005 were $13.96 million and under the FY2004 target figure. Condition met. **Kosrae:** The implied targets were $5.8 million in FY2002, $5.126 million in FY2003, and $5.203 in FY2004. The actual wage bill in FY2003 was $5.126 million and $4.934 million in FY2005. Condition met. **Pohnpei:** The implied targets were $12.9 million in FY2002, $13.094 million in FY2003, and $13.289 million in FY2004. The actual wage bill in FY2003 was $12.550 million and $12.80 million in FY2005. Condition met. **Yap:** The implied targets were $4.510 million in FY2002,

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
					$4.577 million in FY2003, and $4.646 in FY2004. The actual wage bill in FY2003 was $4.277 million, and $4.345 million in FY2005. Condition met.
National (Dec. 2001) All (Aug. 2003)	1c	Soundly manage the FSM Trust Fund	The FSM Trust Fund law is passed and its board is established. (completion date: November 2001)	Not less than 50% of the increase of budgetary support under the Compact Base Grant for FY2002 and FY2003 dedicated to the Stability Account of the FSM Trust Fund FSM Trust Fund fully operational	The increase in budgetary support for each of the 2 years was $17 million, implying that a total of approximately $17 million should be dedicated to the FSM Trust Fund. On 30 September 2004, the Borrower transferred $30 million to the new Trust Fund established under the amended Compact, comfortably exceeding the minimum requirement. Under Compact arrangements, the Trust Fund will now be supplemented with annual payments through the remaining life of the Compact. The Trust Fund is fully operational. Condition met.

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
All	1d	Soundly manage external debt	Total official debt, net of assets held to secure repayment, remains below 24% of the national GDP in FY2001 (completion date: October 2001)	Continued maintenance of official debt remains below 24% of GDP in FY2002 and 2003	The external debt, net of assets held for loan repayments, was 18% as of 30 September 2002, 17% as of 30 September 2003, 17% as of 30 September 2004, and 16% as of 30 September 2005. This is a prudent level of debt that is within the capability of the FSM to repay. There is a general acknowledgement that future borrowing should be undertaken in a cautious manner. Condition met.

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
All	1e	Progress in public enterprise reforms	Draft master plans for public enterprise reform completed (completion date: September 2001)	Master plans for public enterprise reform submitted to each participating legislature At least one public enterprise transformed by each national and state government	The Government has confirmed that the draft master plans for public enterprise reform were submitted to each legislature. **Public enterprise transformation:** **National:** The national capital water system has been transferred from a national Government department to a Pohnpei State-owned utility corporation, resulting in clear improvement of service, clear cost savings to the national Government, and lesser overall cost savings to the utility company that have yet to be quantified. Condition met. **Chuuk:** Contracting out of management of the ice-making plant and catering of meals at the public high school were originally proposed. It was also attempted to revive a failed past attempt at transforming the Chuuk Coconut Authority. However, as of 1 November 2006 no qualifying transformation had even been initiated. Condition not met. **Kosrae:** Kosrae has outsourced catering under its Early Childhood Education Program. Three private sector contractors were selected following a competitive tender process resulting in competitively priced meals and outreach to a larger number of students. Condition met.

Govern-ment	Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
				Pohnpei: Pohnpei's Economic Development Authority has sold three fishing vessels to a private company, resulting in significant financial benefit to the public and less crowding out of the private sector. Condition met. **Yap:** The television service has been transferred from within a state department to FSM Telecom, in effect corporatizing and commercializing it. A subsidized, free service has been upgraded and placed on a fee-for-service basis. Condition met.

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
Section 2: Improve Legal Environment for Private Sector Development					
States	2a	Improve legal environ-ment promoting the use of land and property as loan security	Long-term land lease legislation drafted Mortgage legislation draftf (completion date: September 2001)	Long-term land lease legislation passed Mortgage legislation passed	**Chuuk:** Although the only state to have adopted new legislation in these areas, its "Chuuk State Land Leasing and Lease-Based Mortgage Act" from 2003 contains numerous shortcomings compared to the 1999 model acts upon which it is based, as significant provisions were deleted or diluted. Reinstatement of missing or altered provisions had been encouraged, but recommendations were ignored in the Act as eventually passed in 2003. Specific leasing and mortgage bills agreed with Chuuk in 2005 were never submitted to the legislature. Condition not met. **Kosrae:** The legislature passed bills to establish a Kosrae Leasehold Act and a Kosrae State Mortgage Act. Both were clearly based on 1999 model acts, but contained unfortunate changes, including significant clerical errors. Suitable amendments were enacted in September as S.L. No. 8-130 (leasing) and S.L. No. 8-132 (mortgages) and signed into

Govern-ment	Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
				law on 31 October 2005. Condition met. **Pohnpei:** There was persistent reluctance to change its current leasing approach to conform with the model leasing act. The situation regarding mortgaging was more promising with a bill similar to the model act. Although improvements were made to both bills and were introduced on 29 June 2005, they never advanced within the legislature due to a lack of champions. Condition not met. **Yap:** Early in 2005 Yap had yet to take any action on either land leasing or mortgage reform. Enactment of the two model acts was encouraged, revised as appropriate for Yap. The executive branch was supportive, but took too long getting the bills to the legislature to meet the 1 November deadline. The legislature is currently considering the bills on an expedited basis and enactment is likely soon. Condition not met.

Govern-ment		Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
All	2b	Improve foreign direct invest-ment system		Foreign investment laws amended and/or regulations implemented	**National:** The Government adopted its FIAS I statute in 1997 and regulations thereunder in 1999. FIAS II proposed several changes to both. Bills to amend the statute were introduced in each of the last two congresses but were not adopted. In 2005, after extensive consultations with stakeholders, a suitable bill modeled after the FIAS II proposal was introduced and passed in the September session of the FSM Congress. It was signed into law as Public Law No. 14-32 on 2 November 2005. Condition met. **Chuuk:** The "Chuuk State Foreign Investment Act of 1998" is based on FIAS I, but regulations were never adopted to implement the statute. FIAS II proposed numerous changes to the statute and prompt adoption of complete regulations. As of early 2005 no action had occurred on either front, and suitable legislation and regulations, modeled after the FIAS II proposals, were developed with state officials and contact was made with key legislators. Despite no apparent significant opposition to the proposals, no bill to amend the statute was submitted to the legislature by the agreed deadline, underscoring the inertia characteristic of the Chuuk Government. Condition not met. **Kosrae:** No regulations had been adopted by 2000. FIAS II proposed improvements to the statute and prompt adoption

Govern-ment	Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
				of complete regulations. Although regulations were adopted in 2003, no changes had been made to the statute. The regulations perpetuated the shortcomings of the FIAS I statute ("Kosrae State Foreign Investment Act of 1998") and changes were needed to both. Due to supportive state officials, especially the legislature, desirable amendments to the Kosrae act, modeled after the FIAS II proposals were passed in September and signed into law on 31 October 2005 as State Law No. 8-131. Progressive new regulations, also modeled on FIAS II, were published for public comment by 1 November 2005 and were finalized by mid-December 2005. Condition met. **Pohnpei:** Pohnpei had enacted its Foreign Investors Permit Act of 1986, several years before FIAS I came to the FSM. Amendments were made to that statute in 1999 as a result of FIAS I, but without adopting the stoplight system or many other features of the FIAS approach. Existing regulations were amended in 1999 to reflect these limited legislative changes. FIAS II had urged a complete overhaul of the Pohnpei statute and regulations, however no progress had been made by early 2005. Resistance to reform was significant, in particular from a vociferous faction of the local business community, and even a watered-down reform was not accepted. The antagonistic atmosphere made it

Govern-ment	Policy	Conditions for Board Consideration	Actions to Be Taken Prior to Second Tranche Release (originally August 2003)	Status for Second Tranche Release as of 23 October 2006
				impossible even to introduce a progressive bill. Condition not met. **Yap:** Yap's FIAS I statute and regulations had problems similar to those of other governments. FIAS II proposed changes to both and the statute was repealed and replaced by a new "Yap State Foreign Investment Act" in 2001 (YSL No. 5-72), to which some minor, albeit sufficient, amendments were added in 2002 (YSL No. 5-99). Condition met.

FIAS = Foreign Investment Advisory Service, FSM = Federated States of Micronesia, FY = fiscal year, GDP – gross domestic product.
Source: ADB and FSM Government.