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San Marino: Financial Sector Assessment Program—Financial System Stability Assessment

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Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and European Departments

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February 3, 2010

This Financial System Stability Assessment (FSSA) is based on the work of an IMF Financial Sector Assessment Program (FSAP) mission that visited San Marino during the period November 4 to 18, 2009. The key findings of the assessment are:

- The banking sector in San Marino is small in absolute terms, but represents close to nine times GDP. About half of banking activity involves accepting deposits from Italian customers and placing them with Italian banks, but this line of business is being forced to respond to political, legal, and reputational pressures.
- The assessment of the observance of Basel Committee Core Principles (BCP) showed that the Central Bank of San Marino (CBSM) will need substantially strengthened independence and resources. Although the CBSM has made significant progress, there are still gaps in the regulatory regime and supervisory practices. The CBSM should upgrade its financial regulation in alignment with the EU framework, while strengthening supervision and enforcement. In view of the risks posed by large loan exposures, the CBSM should try to accelerate the transition to full compliance with regulations on loan concentration.
- The most immediate major risk to the financial sector is that of large deposit withdrawals, but credit risk (particularly derived from concentrated lending) is also a significant concern. Hence, preparations for dealing with contingencies—including through cooperation with foreign authorities—need to be accelerated.
- Although official data indicate that the average risk-weighted capital adequacy ratio (CAR) of the banking system was 15.4 percent as of end-June 2009, adjustments made to take into account the revaluation of non traded equity holdings bring that figure down to 11.0 percent.
- The nonbank financial sector in San Marino is embryonic but poses a money-laundering (ML) risk and needs to be more tightly regulated. Anti-money Laundering and Combating the Financing of Terrorism (AML/CFT) requirements should be implemented more effectively. Undue restrictions that impede cross-border regulatory coordination should be removed and cooperation needs to be enhanced.
- The CBSM needs enhancements to its governance model. There are ambiguities in the lines of accountability that compromise the CBSM's independence. A new governance model should introduce a fully professional and disinterested Governing Council.

The team comprised Brenda González-Hermosillo (mission chief), Joseph Crowley, and Samer Saab (all MCM) and Giuseppe Lombardo (LEG) from the International Monetary Fund; Richard Pratt (independent expert), and Maria Alessandra Freni (Bank of Italy). The main authors of this report are Brenda González-Hermosillo and Joseph Crowley with input from the other members of the FSAP team.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

AML	Anti-money laundering
AML-CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCBS	Basel Committee for Banking Supervision
BCP	Basel Core Principles
BdI	Bank of Italy
BIS	Bank for International Settlements
CAR	Capital adequacy ratio
CBSM	Central Bank of San Marino
CCS	Committee for Credit and Savings
CDD	Customer due diligence
CFT	Combating the financing of terrorism
CSSM	Congress of State of San Marino
CRSM	Cassa Di Risparmio di San Marino
DGCB	Director General of the Central Bank of San Marino
EU	European Union
FATF	Financial Action Task Force
FIA	Financial Intelligence Agency
FIU	Financial intelligence unit
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSSA	Financial System Stability Assessment
FT	Financing of terrorism
GCCB	Governing Council of the Central Bank of San Marino
GGCSM	Grand and General Council of San Marino
IFRS	International Financial Reporting Standards
ML	Money laundering
MLA	Mutual legal assistance
MoU	Memorandum of understanding
NBFI	Nonbank financial institutions
NPLs	Nonperforming loans
OFC	Offshore financial center
RIS	Rete Interbancaria Sammarinese
ROAA	Return on average assets
ROAE	Return on average equity
SCCB	Supervision Committee of the Central Bank of San Marino
SD	Supervision Department
SROs	Self regulatory organizations
STR	Suspicious transaction report
TF	Terrorist financing

EXECUTIVE SUMMARY

San Marino is at a major crossroads. Recent events, including the global call for enhanced transparency, are forcing major structural changes in the banking sector, and the regulatory and supervisory regime. Dealing effectively with deposit outflows that result from these changes is the immediate challenge, but credit concerns are also important.

The banking sector in San Marino represents close to nine times GDP. Lending to the nonfinancial private sector represents about half of banking assets in San Marino, while the rest is mostly placed with Italian banks. Sammarinese and Italian nonfinancial customer deposits constitute the main financing source. Bank performance is under pressure from the global economic crisis and a rise in operating costs.

Although official data indicate that the average risk-weighted CAR of the system was 15.4 percent as of end-June 2009, adjustments made by the FSAP team bring that figure down to 11.0 percent. Two banks with over a third of total banking sector assets may have CARs below 7 percent. Banks that do not meet the prudential minimum should be recapitalized immediately.

Stress tests indicate that the main vulnerabilities of the Sammarinese banking sector relate to deposit outflows or to a deterioration of credit quality, and these risks are particularly high for the largest bank. Deposit outflows have been driven by external factors, in particular an Italian tax amnesty and investigations related to criminal activities including ML. Most banks are liquid and would be resilient to outflows as long as they can easily liquidate their securities portfolios or borrow from other more liquid banks, but the largest bank is vulnerable. The deposit outflows could be permanent, eventually resulting in a contraction of the banking sector. Banks are also vulnerable to a deterioration of credit quality, particularly with respect to their exposures to concentrated lending. Banks are not vulnerable to exchange rate risk, since almost all assets and liabilities are denominated in euros.

There is no effective mechanism to provide liquidity to banks. San Marino uses the euro, but is not a member of the European System of Central Banks. Short-term repo or central bank lending facilities are not currently available and the CBSM has insufficient resources to act as a lender of last resort. Several mechanisms to improve liquidity management and provide emergency liquidity assistance were discussed with the authorities at the CBSM.

Future sustainability requires a more resilient financial system, based on stronger financial regulation and supervision. San Marino either must find a new business model that complies with international standards and increased transparency, or else reconcile itself to a smaller, more inward-looking financial sector. Stronger regulation, better supervision, and further amendments to secrecy legislation to allow full cross-border regulatory coordination are needed.

The nonbank financial sector in San Marino consists of just over 50 small companies, but has growth potential. The sector needs better regulation and oversight, notably with regard to customer due diligence (CDD). Two asset management companies and two foreign life insurance companies have recently begun operations. There is no stock exchange or any other major financial market.

The CBSM has made commendable efforts to implement new laws and regulations and create a regulatory regime that approaches international standards, but supervisory practices still need enhancement. The regulatory regime is not yet being fully enforced, some gaps remain, and the CBSM needs more resources. Furthermore, compliance practices of financial institutions can only be changed with a considerable delay. The CBSM has performed only two full-scope on-site bank inspections because of limited resources, although there have been a number of more limited on-site inspections of banks and full inspections of financial and fiduciary companies.

Governance must be enhanced for the CBSM to be more effective. The governing body of the CBSM should be subject to clearer and stronger accountability, and be more independent from government.

San Marino achieved considerable progress in bringing its AML/CFT legal framework in line with international standards. However, the authorities will still need to follow up on implementation of the new regulations and cope with the legacy of customers that were accepted in the past when AML/CFT policies were weak.

Table 1. Summary of Key Recommendations

Measures	Timeline
Highest Priority	
Secure contingent emergency lines of credit with other central banks.	Immediate
Recapitalize banks that do not meet prudential requirements.	Immediate
Strengthen supervision, particularly by acquiring resources to conduct sufficient full scope on-site inspections.	Ongoing
Facilitate cross-border flows of information and allow foreign supervisors to make on-site visits to foreign banks in San Marino.	Short term
Ensure that financial institutions, particularly fiduciary firms, are properly and effectively implementing the CDD requirements.	Short term
Introduce a new governance model for the CBSM.	Medium term
Introduce prudential measures that contain banks' liquidity risks.	Medium term
Upgrade financial regulation, preferably in line with EU practices.	Ongoing
Take all possible steps to accelerate the transition period to full compliance with the regulations on loan concentration.	Medium term
Increase staff of the Financial Intelligence Agency (FIA), the CBSM supervision units and the Judiciary responsible for AML/CFT.	Immediate
Other	
Introduce measures to facilitate self-insurance among banks.	Short term
Finalize supervision manuals.	Short term
Seek to obtain access to the EU payment system, and ECB refinancing facilities.	Medium term
Undertake reform of fiduciary companies in order to strengthen transparency in corporate ownership and clarify the scope of activities in which these companies can engage.	Short term
Enhance collaboration between the FIA and the CBSM in the area of financial sector AML/CFT supervision.	Immediate
Reconsider some of the FIA's non-core financial intelligence unit's (FIU) responsibilities (such as the power to act as judicial police on delegation from the judicial authority) in the light of the FIA's limited human resources.	Medium term
Ensure stringent customer due diligence at all financial institutions, in particular the fiduciary companies.	Short term

Table 2. San Marino: Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat Sometime in the Next Three Years	Expected Impact on Financial Stability if Threat is Realized
Large withdrawals of deposits, particularly by Italian depositors.	*Assessment: high* San Marino banks have enjoyed an artificially high supply of deposits because of favorable regulation and minimal reporting requirements. As regulation and transparency requirements are strengthened this advantage will disappear. Furthermore, an Italian tax amnesty has already resulted in the repatriation of large amounts of deposits. Following past Italian tax amnesties, deposits have returned to San Marino. But this time the outflow is more likely to be permanent because of the changes in regulation and transparency.	*Assessment: medium* The effect could be minimal. Banks in San Marino balance much of their deposits with Italian securities that are mostly liquid. If these deposits are withdrawn, Sammarinese banks should in principle be able to liquidate these securities portfolios to satisfy the liquidity demands. But the degree of liquidity of some of these assets for some banks is uncertain. Some small banks could face constraints in the event of moderate outflows. One large bank faces uncertainty regarding its ability to liquidate a large share of its securities portfolio. A contraction in the banking sector—caused by deposit withdrawals—could have a significant impact on economic activity and on the fiscal accounts.
Worsening of loan quality, most likely through deterioration in the economic outlook.	*Assessment: medium* San Marino has suffered a moderate contraction of GDP as a result of the crisis, but conditions could worsen. Italy has suffered a significant decline in GDP and this slowdown could spread to San Marino. Weak supervisory oversight adds an element of uncertainty about loan quality.	*Assessment: high* The threat is lessened by the fact that nonbank lending portfolios of banks in San Marino represent less than half of total assets and reported nonperforming loan (NPL) rates are low. However, exposures are large relative to GDP and the threat is considerably increased by the high levels of loan concentration.
Collapse of an Italian bank to which banks in San Marino are exposed.	*Assessment: medium* Banks in San Marino have large positions in Italian banks, which could find themselves in difficulty because of the global financial crisis and regional exposures. One important borrower is facing very difficult conditions.	*Assessment: high* Banks in San Marino have exposures that are large compared to GDP.

I. Background

A. Macroeconomic Background

1. **San Marino, a small sovereign enclave in Italy of about 30,000 people, was impacted later than other countries in the region by the global financial crisis.** Growth remained positive until a sharp contraction in the last quarter of 2008 (-6.8 percent Q/Q, and -1.1 percent for the whole of 2008; Appendix Table 1). The outlook worsened in 2009, with projected growth down to -5 percent. The unemployment rate is expected to reach 5.1 percent in 2009. Inflation was 2.3 percent in July 2009 and is expected to remain low.

2. **The public debt is small and the central government balance has been in surplus since 2003, but the economic slowdown will result in a significant deterioration of fiscal accounts.** The central government balance is expected to be -4.3 percent of GDP in 2009 and -3.4 percent of GDP in 2010. The financial sector accounts for about 10 percent of total government revenues.

B. Recent Developments

3. **A series of recent events has strained San Marino's institutional capacity.** San Marino received a critical AML/CFT assessment by MONEYVAL in 2007 (report adopted in April 2008).[1] San Marino was subsequently subjected to MONEYVAL's Compliance Enhancing Procedure. In April 2009 San Marino was put on the OECD "grey list" of countries that have yet to fully implement OECD tax standards.

4. **ML and tax concerns have also strained the relationship between San Marino and Italy, San Marino's biggest trading and financial partner.** In September 2009 the Italian government adopted a tax amnesty law that allows Italian individuals and businesses to avoid administrative and criminal sanctions if their off-shore assets are disclosed and at repatriated to Italy before December 15, 2009.[2] On March 31, 2009, the two countries signed a General Economic Cooperation Agreement providing for cooperation on fiscal and financial matters that will be governed by two other agreements. Of these two agreements, the Financial Cooperation Agreement was signed on November 26, 2009, while signature of the Protocol amending the March 2002 Convention on Double Taxation is still pending.

5. **San Marino's reputation has suffered from cross-border judiciary actions.** In 2008-09, two major investigations conducted by the Italian judicial authorities led to the arrest of the top management of two Sammarinese banks—including from Cassa di

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[1] MONEYVAL is the Committee of Experts on the Evaluation of AML Measures and the Financing of Terrorism established by the Council of Europe, of which San Marino is a member.

[2] On December 16, 2009, the deadline was extended to April 2010.

Risparmio di San Marino (CRSM), San Marino's largest bank—on various criminal charges, including ML. The arrests were later revoked but criminal investigations continue. Subsequently, the Bank of Italy (BdI) revoked the authorizations granted to the CRSM as shareholder of the Delta Financial Group based in Italy, and placed Delta under special administration. CRSM was negotiating with potential buyers of its Delta stake at the time of the FSAP mission.

6. **The Delta developments brought unwanted attention and scrutiny to the CRSM.** Fitch downgraded both the sovereign rating of San Marino (currently at AA-) and CRSM's rating (currently at BBB-) three times during the course of 2009. They expressed concerns over the financial soundness of the Delta group, CRSM's heavy exposure to Delta, and the size of CRSM relative to the Sammarinese banking sector and GDP.

7. **The Sammarinese banking system faces liquidity pressures, as Italian deposits are repatriated due to the tax amnesty and because of a general erosion of confidence due to the CRSM/Delta situation and ML concerns.** The banking sector has high levels of liquidity, but San Marino lacks traditional liquidity management tools and facilities.

8. **Steps to address the negative political and reputational concerns, including bringing the institutional framework in line with FATF standards, have had positive results.** In September 2009, San Marino was moved to the OECD 'white list' of countries that have substantially implemented OECD tax standards and MONEYVAL lifted the Compliance Enhancing Procedure. The next MONEYVAL on-site mutual evaluation of the Sammarinese AML/CFT system is planned for March 2010.

II. Overview of the Financial Sector

A. Banking Sector

9. **The banking sector in San Marino is small in absolute terms but represents close to nine times GDP (Appendix Table 2).** Total assets stood at €11.5 billion as of end-June 2009. The largest of the 12 banks is the locally owned CRSM with a third of banking sector assets. The banking sector is highly concentrated, with the top three banks accounting for almost three quarters of total assets and deposits. Six banks are majority foreign-owned, including the Banca Agricola Commerciale, with over a sixth of banking sector assets. Of the six foreign banks, four are owned by foreign holding companies that are at least partly owned by Sammarinese individuals. Foreign-owned banks have slowly been increasing their overall market share (Figure 1). The proportion of assets held in Sammarinese banks that are owned by foreign banking groups is 25 percent.[3]

[3] The main entry vehicle of foreign banks in San Marino has been through subsidiaries of Italian banks, though some foreign banks are owned by private shareholders.

10. **San Marino's banking sector relies heavily on foreign intermediation (Box 1, Appendix Table 7).** A large share of banks' assets is placed with Italian banks or foreign securities. Banks liabilities consist mostly of retail deposits and securities (Figure 2). A strict bank secrecy regime, favorable taxation, light regulatory burden and free movement of capital—in particular to and from Italy—has made San Marino attractive to foreign depositors. But this business model is currently being challenged by international pressures for more transparency in cross-border financial transactions.

Box 1. San Marino as a Financial Center: A Comparison

San Marino can be considered an offshore financial center (OFC) because it is a jurisdiction whose financial sector accounts for a significant and disproportionate share of its domestic economy, and because a large share of financial transactions within the jurisdiction is conducted on behalf of clients who reside outside that jurisdiction. In addition, San Marino features a high level of banking secrecy common to many OFCs, which helps attract foreign deposits and business (Appendix Table 7).

However, San Marino is unusual among OFCs in that the financial sector has developed primarily to serve the domestic population and provide services to other (largely Italian) residents, resulting in strong links with the real economy. Consequently, direct lending is a major part of the rather basic business model of San Marino banks. Insurance and fund management are not yet major activities.

11. **Lending to the nonbank private sector represents about half of Sammarinese banking sector assets (Figure 3).** The two largest components of this lending are loans to nonbank financial companies (which in turn make their own loans, mostly abroad, with these borrowed funds) and lending to households. Over the past three years there was a large buildup of assets (net of the large Delta acquisition),[4] whereas household lending grew more slowly than total lending during this time. Banks also engage, albeit marginally, in fiduciary activities and asset management services on behalf of clients.

12. **Official data indicate that the risk-weighted average CAR of the banking system was 15.4 percent as of end-June 2009. However, adjustments to banks' capital to reflect revaluations of untraded equity holdings bring this figure to 11 percent.[5]** Two banks with over a third of the total banking sector assets may have CARs below the required transitional capital adequacy ratio of 7 percent. Another bank's CAR would fall below the 11 percent ratio that is required for all banks by 2013.

[4] Delta's loan portfolio is primarily consumer lending, which is captured under the "households" category.

[5] These adjustments were based on the results of independent assessments which addressed the value of banks' holdings of untraded equity.

13. **Banks that do not meet the current prudential minimum CAR ratio should be immediately recapitalized.** In mid-January 2010, the shareholders of the CRSM unveiled a plan to strengthen its financial position, which had suffered from its exposure to Delta. The plan included: (i) a capital injection of € 100 to € 150 million, with contributions from the government, the local banking sector, Sammarinese private investors, and the current shareholders; and (ii) issuance of medium term bonds. The CRSM indicated that the plan would bring the bank's CAR above 11 percent.

B. Nonbank Financial Sector

14. **The nonbank financial sector in San Marino is embryonic.** It consists of 2 asset management companies, 2 recently licensed foreign life insurance companies, and over 50 fiduciary, leasing, factoring, and small consumer lending companies. The assets and income of these companies have been growing rapidly during the past two years, but none is yet of significant size.

15. **San Marino has no stock exchange or any major financial markets.** Sammarinese entities have recently begun issuing bank bonds, as well as a small number of financial or commercial company bonds.

III. Vulnerabilities, Banking Soundness, and Stress Testing

A. Assessment of Risks

16. **The most immediate risk for the banking system is related to deposit outflows.** The CBSM's lack of resources to address even moderate liquidity shocks exacerbates this risk. Although many Sammarinese banks have adequate liquidity, they are generally not willing to lend to other banks.

17. **The high proportion of nonresident deposits and the concentration of large deposits increase the vulnerability to outflows.** At end-2008, over 60 percent of deposits were held by nonresidents. At end-June 2009, the 10 largest depositors at each bank in San Marino held 15 percent of all the deposits in Sammarinese banks, and the largest 10 non-resident deposits accounted for 8 percent.

18. **Permanent deposit outflows would shrink banks' balance sheets and lower their incomes.** In 2008 net interest income for banks was approximately three quarters of total gross income. A significant share of this net interest income results from accepting deposits at low rates and placing them outside San Marino at better rates, earning a comfortable spread that will mostly be lost if the outflows become permanent.

19. **Credit quality could worsen, affecting the value of (domestic and foreign) customer loans and securities.** Rapid lending growth over the past three years coincided with an increase in NPLs (Figure 4 and Appendix Table 3). Most lending (including

consumer lending) is collateralized and banks have adequate loan-loss provisions. However, a deterioration in regional economic conditions could reduce the quality of customer loans. Similarly, international events (including reputational risks) could reduce the stability of any of the institutions on which Sammarinese banks have claims. Various stress tests provide an assessment of the relative vulnerabilities (see section III.B below).

20. **Sammarinese banks' lending to the nonfinancial private sector is highly concentrated.** The single largest customer loan at each bank in San Marino combined adds up to over a quarter of total loans, and the largest 10 loans at each bank account for over 40 percent of the total. For many banks, failure to pay by a small group of borrowers could have a severe impact on capital adequacy. Sammarinese banks are also exposed to the Italian banking sector. While Italian banks have so far survived the global crisis relatively intact, this episode demonstrates that cross-border banking risk is of concern.

21. **Banks in San Marino are not exposed to exchange rate risk.** The vast majority of assets and liabilities are in euros.

B. Stress Tests

22. **Stress tests to assess the risks described above were conducted and discussed with the CBSM.** They covered outflows of deposits and adverse movements in credit quality and interest income (Appendix Table 8). An alternative liquidity test was also conducted to test different rates of outflows for different types of deposits (Box 2). The base case scenario for the stress tests incorporates adjustments to the official data as of end-June 2009 on banks' capital, reflecting revaluations of banks' holdings of untraded equity. These revaluations were based on independent assessments made following the FSAP mission. The key results are summarized below.

23. **Serious liquidity pressures could emerge at some banks, including the largest one, due to the repatriation of Italian investments.** Moderate increases in outflows could force the largest bank and some small banks to liquidate loans, while other banks would remain resilient in most of the outflow scenarios considered. The degree of resilience depends critically on the marketability of banks' securities portfolios and, in extreme cases, on the ability of banks to sell or borrow against loans. For example, if outflows were to reach 14 percent of total deposits and securities, the largest bank would have to start liquidating customer loans if its securities portfolio associated with Delta Group were unmarketable. If the Delta Group securities were marketable, however, outflows could reach one third of deposits before this bank would have to liquidate loans. Uncertainty in the redemption value of assets sold under pressure reduces the confidence level of the test results.

24. **Based on 5 and 25 percent discounts on the liquidation value of banks' securities and customer loans, respectively, and nonmarketability of Delta assets held by the largest bank, stress tests suggest that the largest bank and some smaller banks could be vulnerable to large** outflows **in the short-run.** If outflows were to reach 29 percent of total

deposits and securities, over a third of the assets of the banking system would be in insolvent banks. Beyond this threshold, the situation would not worsen much until outflows increased to well over 50 percent—at which point some large banks would start to fall below the 7 percent CAR or become insolvent. These results are sensitive to the assumptions related to the discount on the sale of assets. If the discounts on securities and loans increased to 10 and 75 percent, respectively, an outflow of as little as 15 percent of deposits could make the largest bank insolvent.

25. **Most banks appear significantly vulnerable to potential deterioration in credit quality.** The vulnerability comes both from customer loans and from loans to banks. Customer loans represent a larger share of banks' portfolios than loans to banks, particularly for less well-capitalized banks. The banking system can withstand comparatively larger losses on loans to foreign banks, but loans to banks are more concentrated and are therefore also vulnerable.

26. **Uncertainty regarding the value of the Delta Group is a major vulnerability for the largest bank.** The value of the direct portion of this claim represents over six times the banks' capital. If 16 percent of the value of the direct exposure to Delta were lost, the parent bank would be insolvent. This does not take into account that a large share of the parent bank's loan portfolio (equal to over seven times the parent bank's capital) was recently bought from Delta and could be less sound than the rest of the bank's loan portfolio.

27. **Banks' vulnerability to large nonbank borrowers and connected nonbank groups is worrisome.** If a quarter of the largest loan at each bank had to be written off, two thirds of the assets of the banking system would be in banks below 7 percent CAR and almost half would be in insolvent banks.

28. **The banking system is vulnerable over the medium run to declines in income.** If net interest income declined by half, the gross income of the banking system would decline by about a quarter.

C. Structural Sustainability

29. **San Marino cannot participate completely in the global financial market, unless it fully adopts and implements international standards of regulation and transparency.** However, this transition will undermine San Marino's financial business model, which has relied heavily on weak regulation and confidentiality. Notwithstanding the commendable efforts of the CBSM to implement the new laws and regulations, it will inevitably take a considerable time before the gains from enhanced regulation are fully realized.

30. **San Marino needs a medium-term plan of development for financial services.** Financial institutions must look for comparative advantages, while complying with international standards. This will involve the acquisition of new skills—possibly for investment advice or other wealth management services. The authorities should therefore

remove, at least temporarily, the constraints on the recruitment of staff from abroad. There should also be a careful review of the entry conditions for new industries, including licensing requirements, to balance development needs with soundness concerns. In addition, they should examine the optimal (smaller) size of banks relative to the country's GDP so that systemic risks are contained in the future and resolution frameworks are manageable.

IV. Risk Management, Safety Net, and Market Infrastructure

A. Risk Management and Liquidity Crisis Preparedness

31. **There were only a few liquidity requirements on banks prior to the announcement of the 2009 Italian tax amnesty, but the CBSM is now actively monitoring banks' liquidity positions with daily reports.** Although the CBSM issued guidelines broadly following Basel principles and made bank directors responsible for liquidity management, the introduction of minimum liquidity ratios such that enough liquid assets are in the books of banks to cover for the withdrawal of short-term deposits would be advisable given the vulnerability of the financial system to liquidity shocks.

32. **The CBSM does not have an effective market mechanism to provide or manage liquidity and there is no established interbank market in San Marino.** Interbank lines of credit are not the norm and are only obtained on a case-by-case basis. Until recently, there was little demand for liquidity management facilities since all banks had significant excess liquidity.

33. **At the time of the FSAP, the Sammarinese financial system had adequate liquidity at the aggregate level, but some individual banks faced strains.** Some domestic banks tried unsuccessfully to secure lines of credit from other domestic banks, while foreign banks were able to obtain credit lines from foreign parent companies. One domestic bank had begun to arrange for a modest lending facility from another local bank, seemingly related to potential merging plans. Several banks indicated that they would not provide lines of credit to domestic counterparts without CBSM guarantees.

34. **So far, all the banks have been able to meet all depositors' requests for withdrawals, but the extension of the tax amnesty until end-April 2010 could lead to continuing pressures.** As of December 15, 2009 about 29 percent of total deposits and related investments had benefited from the tax amnesty, with an impact on banks' liquidity of € 2.3 billion. At least an additional € 220 million is expected to be physically repatriated to Italy before June 15, 2010.

35. **Several mechanisms to provide and allocate liquidity were discussed with the CBSM.** These mechanisms included measures that could be implemented quickly, as well as some that would require time to develop. The authorities were warned of the risks of schemes that would transfer risk to the CBSM (and hence to the government), and of involuntary schemes based on capital controls that could discourage depositors from coming to San

Marino. Also it was suggested that measures implemented in order to prevent or contain a systemic liquidity crisis should be formulated with provisions that would make them *temporary,* based on a thought-out plan to unwind them when conditions stabilize.

36. **The various schemes envisaged by the CBSM to contain a potential liquidity crisis in the near term include the following**:

a. *A voluntary and incentive-based facility whereby banks with excess liquidity can deposit those funds with the CBSM at a competitive rate. These funds could then be lent to banks facing liquidity needs.* This type of facility would shift liquidity risk, and potentially credit risk, to the CBSM. Effectively, these risks would be ultimately borne by the Sammarinese government.

b. *Establish lines of credit or repo operations with the BIS, other central banks, or foreign banks using CBSM's own portfolio as collateral.* Although the CBSM's portfolio was noted as being of high grade quality (largely composed of sovereign bonds and AA securities), it is small relative to the size of the Sammarinese banking sector, and would only be able to finance moderate liquidity needs.

c. *CBSM's repo operations using securities borrowed from domestic banks.* The CBSM could borrow securities owned by domestic banks and repo them with foreign counterparts. However, the fact that banks themselves cannot do this directly with offshore counterparties, or with foreign banks established in San Marino, suggests that the quality of these securities may not be high.

37. **Other measures were considered by the CBSM to contain liquidity pressures and improve management of overall liquidity risks in the future.** The possible measures include the following:

a. *Introduce a requirement that banks deposit reserves with the CBSM at remunerated market rates.* Subsequent to the completion of the FSAP mission, a law was introduced on December 3, 2009 which required banks to place 8 percent of all deposits collected in an account with the CBSM that will be remunerated. Any liquidity assistance provided to another bank would be taken into account in the computation of the funds required to be deposited with the CBSM.[6] The authorities have indicated that the measure has contributed to an appropriate redistribution of liquidity in the system, and has thus far helped avert a liquidity crisis.

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[6] This measure is deemed to be temporary, ending in January 2010. It applies to interbank deposits as well as customer deposits. Deposits required to be held with the CBSM will be blocked for the whole (monthly) maintenance period, but derogation to the general requirement may be granted based on demonstrated liquidity stress.

b. *Issue external sovereign bonds and use the proceeds to guarantee illiquid, but solvent, financial institutions*. There is merit in building a sovereign reserve cushion in light of the very low level of foreign government debt, but that doing this during the peak of the banking pressures may be quite costly.

c. *Self-insurance against potentially systemic liquidity risks*. Financial institutions could contribute proportionally to a liquidity insurance fund administered by the CBSM. That fund could be used for the purpose of guaranteeing retail deposits in Sammarinese banks.

d. *Secure a financial agreement with the Italian authorities such that Sammarinese banks can have access to the refinancing facilities and payment systems in the realm of the Eurosystem (through the Bank of Italy).* However, this option is likely to be practically only implementable over some time because a monetary agreement would need to be reached with Italy and the European Community.

V. Institutional, Legal, and Regulatory Frameworks

A. Payment System

38. **San Marino uses the euro as its currency according to the Monetary Agreement between San Marino and Italy on behalf of the European Community.** However, the CBSM does not issue euros except for commemorative coins minted on rare occasions; nor does it perform other monetary policy functions, such as management of reserves, or open market or foreign exchange operations. Banknotes and coins are provided by the Italian Central Bank through an Italian commercial bank that is authorized to transmit them to the CBSM.

39. **San Marino has a domestic payment system, monitored by the CBSM.** The system works on a gross settlement basis with rules on settlement finality. All San Marino banks keep specific accounts centralized with the CBSM and participate in Rete Interbancaria Sammarinese (RIS), an interbank communication network.

40. **The CBSM executes payment transactions with foreign countries through a network of correspondents.** The SWIFT network assures international interbank communication. The CBSM also participates in the Italian clearing system for low-value payments denominated in euro (BI-COMP) and has indirect access to TARGET2, the European gross settlement system for the settlement of large amounts.

41. **San Marino commercial banks can access the European payment system indirectly through Italian or European correspondent banks.** Of the 12 banks, 10 have obtained the required CBSM authorization to execute international payment transactions and currency activities. In practice, access is provided via two correspondent Italian banks. The

two Sammarinese banks that are owned by large Italian banks have payment services provided through their own banking groups.

B. Key Issues in Financial Sector Supervision

Governance

42. **The CBSM needs enhancements to its governance model, in particular to resolve ambiguities in the lines of accountability.** The CBSM has a chairman, a governing council (the Governing Council of the Central Bank of San Marino (GCCB)), and a director general (the Director General of the Central Bank of San Marino (DGCB)). The DGCB is the chief executive of the CBSM and is also the chairman of a supervision committee (the Supervision Committee of the Central Bank of San Marino (SCCB)). The present arrangements result in weak accountability, ambiguity in reporting lines, inadequate resources for the CBSM and inappropriate political influence over regulatory decisions.

43. **The statute is unclear about the accountability relationship between the GCCB and SCCB.** The SCCB does not regard itself as formally accountable to the GCCB though it does have to inform the GCCB of its supervisory activities. This creates further uncertainty about the relationship between the DGCB (as Chairman of the SCCB) and the Chairman of the CBSM itself. The absence of clear lines of responsibility within the CBSM makes it impossible to develop proper accountability to parliament.

44. **The CBSM Statute has strong provisions limiting GCCB members' conflicts of interest but, as in many small jurisdictions, it is difficult to avoid strong personal and commercial links between governing body members and banks and other regulated entities.** The decision to give supervisory powers to the SCCB is intended to minimize the conflict of interest that may occur if GCCB members were to be involved in day to day supervision. This has been achieved at the expense of clarity about accountability relationships.

45. **A new governance model is necessary, the first element of which should be a fully professional and disinterested GCCB.** Other small countries that face the same difficulty in finding disinterested governing body members have appointed a number of foreign members, using an open and transparent process. The authorities should also give the DGCB full membership in the GCCB to increase the professionalism of the GCCB and should remove the role of the Committee for Credit and Savings (CCS) in nominating GCCB members.

46. **The GCCB should be held accountable by the Grand and General Council of San Marino (GGCSM) for its performance.** Clarity in accountability could be achieved by giving the GCCB full responsibility for all the functions of the CBSM and removing any reference to the SCCB in the CBSM Statute. The GCCB could then decide to fulfill its

responsibilities by taking over the current functions of the SCCB itself, or, to delegate its day to day decisions to the DGCB and/or internal committees of the executive.

47. **With clearer and stronger accountability arrangements, the CBSM should also be given more independence.** The DGCB has no protection against arbitrary dismissal, and Law no. 165 should be revised to remove the role of the State Congress in licensing decisions. The provision of a license should be based solely on the assessment of prudential factors and on the fitness and properness of the license applicant and its key staff. The authorities should amend Article 101 of Law no. 165 to clarify that the CCS is only able to set the CBSM high level objectives (as is already provided for in Article 48 of the CBSM Statute). The authorities should also give the DGCB statutory protection against arbitrary dismissal.

48. **The CBSM should be provided with a dependable and autonomous source of funding.** Currently it relies on fees from supervised entities (€1 million), trading income (€6 million) and fees for banking services to the government (€3 million) as part of an agreement that the government has failed yet to renew. Meanwhile, the CBSM funds but has no control over the budget of the Financial Intelligence Agency (FIA). Supervision costs should be covered by fees and government subventions (the latter being guaranteed for a three year term, subject to fiscal emergencies). The costs of providing services and of the FIA should be reimbursed by the Government in full on the basis of audited accounts.

Supervisory effectiveness

49. **The CBSM has made good progress in drafting new regulations and has created a regulatory regime for banks that approaches international standards, but implementation is taking time.** The law and regulations now in effect provide most of the necessary supervisory powers and a reasonably comprehensive regulatory framework. However, the regulatory regime is not yet being fully enforced and some gaps remain, notably related to international cooperation and provisions for specific capital requirements dealing with market risk, interest rate risk, and operational risk. And some of the key requirements on risk-based capital, large exposures, and connected lending are subject to five year transitional provisions.

50. **The CBSM is developing its supervisory techniques but needs more resources to meet its objectives.** It has performed only two full-scope on-site bank inspections because of limited resources, although there have been a number of more limited on-site inspections of banks and full inspections of financial and fiduciary companies. The supervisory manuals for on-site and off-site supervision are not complete, although the supervisory staff has a clear understanding of their role, and inspections have been effective. The CBSM has not yet adopted a policy on the level of on-site visits it considers necessary and so is unable to state the resources it needs. The CBSM should quickly finalize manuals for supervision and a model for analyzing bank risks, and complete a first round of visits to banks to begin an

assessment of resources required for proper supervision. It is vital that the authorities agree to provide the resources necessary for the CBSM to do its job.

Cross Border Collaboration

51. **San Marino has made solid progress on international cooperation, as acknowledged by the OECD.** However, further efforts are needed to establish or reinforce bilateral relations. A critical agreement with the Italian authorities outlining the conditions for San Marino banks to gain direct access to the EU payment system was signed, but the CBSM has signed no other memoranda of understanding (MoUs), other than one on supervision with the National Bank of Croatia.

52. **The negotiation of cooperation agreements would be facilitated by the adoption and implementation of a sound regulatory framework.** The authorities should make efforts to adopt rules and supervisory approaches consistent with those in place in Italy and the rest of the EU.

53. **The banking law of San Marino should unambiguously allow subsidiaries of foreign-owned banking groups to provide complete information to parent banks.** The bill on the scope of the bank secrecy should be approved without delay, and the CBSM should be empowered to exchange information more freely.

C. Anti-Money Laundering and Combating the Financing of Terrorism

54. **The level of domestic-generated proceeds of serious crime is low, but San Marino is vulnerable to ML of proceeds of crimes committed abroad (mostly in Italy).** While these proceeds have predominantly been related to tax evasion, statistics provided by the authorities also indicate other serious predicate crimes to ML.[7] Until very recently, several factors have created an environment favorable to ML, including strict financial secrecy; opportunities to systematically hide beneficial ownership, financial instruments that ensure anonymity and easy transferability; the predominant use of cash, and the widespread use of checks with multiple endorsements.

55. **Following the 2008 MONEYVAL mutual evaluation report, the Sammarinese authorities acted swiftly and steadily to fix shortcomings and fill gaps in the AML/CFT regime.** The 2008 AML/CFT law and the FIA's regulations establish a modern, risk- based AML/CFT regime, and constitute a significant improvement of the AML/CFT requirements first established in 1998; the FIA was established as an operationally independent agency within the CBSM; financial secrecy privileges can no longer be invoked in AML/CFT inquiries; bearer passbooks were prohibited and phased out; mechanisms to ensure better corporate ownership transparency were established, cross border transportation of currency

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[7] Such as drug trafficking, mafia-type criminal organization, illegal banking activities, fraudulent bankruptcy and fraud.

must be declared; and the use of cash and multiple endorsement checks was restricted. The FIA has undertaken several on-site inspections to check compliance of the AML/CFT requirements. Certificate of deposits in bearer form were prohibited and reimbursement of large ones already in circulation require reporting to an AML/CFT compliance officer. Financial institutions, especially banks, have begun implementing—with mixed results—the new AML/CFT requirements. A visible sign of improvement is the steady increase of the number of suspicious transactions reports (STR) received by the FIA during 2007-2009. The FIA's exchange of information with foreign financial intelligence units (FIUs) and provision of mutual legal assistance (MLA) have also increased.

56. **The past record of weak AML/CFT policies, supervision, and inspections has left a legacy of problems.** Implementation of the new requirements is uneven across the financial sector. Special attention should be paid to the verification of customers' sources of funds, and customers' risk-based profiling, especially for legacy customers (accepted prior to the enactment of the new AML/CFT law), and non-resident customers. Effective CDD and ready availability of comprehensive information on the clientele is of paramount importance not only for the financial institutions, but also for the authorities to effectively undertake financial analysis, criminal investigations and supervision. The FIA and CBSM should coordinate their enforcement efforts to maximize effectiveness and provide more guidance on what constitutes a high-risk customer.

57. **The fiduciary companies weaken the AML/CFT regime.** A large share of ML cases refers to clients of fiduciaries. The legal and regulatory framework governing these companies remains fragmented and weak. Mechanisms to ensure transparency in the ownership of fiduciary companies should be enhanced and the scope of the activities in which fiduciary companies can engage should be clarified. Some fiduciary companies offer services that appear designed simply to obscure the connection between assets and their beneficial owners. Anecdotal evidence indicates that, until recently, fiduciaries accepted large amounts of cash from clients and handled abnormally large volumes of multiple-endorsed checks. Other weaknesses include that fiduciaries can be relied upon as third parties for the identification of customers, and that financial institutions, including banks, can apply simplified due diligence to bank accounts opened by fiduciaries on behalf of their clients.

58. **The authorities' serious commitment to AML/CFT is undermined by scarce human resources.** Understaffing affects the FIA (which has several other responsibilities in addition to its core function, such as acting as judicial police on delegation from the judicial authority), the Supervision Department of the CBSM, and especially the judiciary, where currently only one investigative judge and two aides are responsible for ML. The CBSM and the FIA have signed a MoU on supervision, but a more structured and risk-based planned approach is needed.

ANNEX—OBSERVANCE OF FINANCIAL SUPERVISION STANDARDS AND CODES—SUMMARY ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES

This Annex contains a summary assessment of the observance of the Basel Core Principles for Effective Banking Supervision (BCP). This assessment was conducted as part of the FSAP evaluation of the San Marino financial system from November 4 to November 18, 2009. The supervisory framework was assessed against the BCP methodology issued in October 2006. The assessment was conducted by Mr. Richard Pratt, an independent consultant with the IMF, and Ms. Maria Alessandra Freni, an expert from the Bdi.

The assessment was based on a range of sources, including:

- A self-assessment of compliance with the 25 BCPs completed by a CBSM team, the legal and regulatory framework for banking supervision, bank annual reports, guidelines issued by the CBSM, as well as numerous other documents made available by the CBSM.

- During their stay, the assessors held extensive discussions with the supervisory staff of the CBSM, as well as with representatives from the Ministry of Finance, and other banking and financial institutions.

The CBSM is developing the bank supervisory regime from a very low base, but the staff is professional and committed and is starting to conduct on-site and off-site supervisions. Progress has been good.

Summary, Key Findings and Recommendations

Summary

59. **The CBSM, as the supervisory authority, is developing the bank supervisory regime from a very low base and will need enhanced independence, resources, and support over many years if it is to complete the task of rebuilding San Marino's reputation.** Prior to 2005, regulation in San Marino was in an extremely underdeveloped state. The CBSM has assisted in drafting laws and has issued regulations and recruited more resources. It has also had to deal with a series of emergencies. The staff is professional and committed and is starting to conduct on-site and off-site supervisions. Progress has been good but a substantial period of effective enforcement will be needed before San Marino can rebuild its reputation, which has suffered from limited regulation, the consequent weakness of banks, and apparent malpractice in certain institutions.

Information and Methodology used for Assessment

60. **The mission followed the 2006 Core Principles methodology (Essential Criteria).** The mission reviewed the self assessment and other CBSM data, including the CBSM web site, CBSM statute, the supervisory law, the anti money laundering law and key regulations,

and Instructions and Circulars issued by the CBSM and the FIA. The mission met with representatives of the Government, the CBSM, the FIA, banks, fiduciary companies, and securities and accountancy firms. All were frank and open with the mission.

Institutional and Macro Prudential Setting, Market Structure—Overview

61. **The CBSM is the sole regulatory body.** It was instituted in its present form by Law 96 of 2005 and its comprehensive supervisory powers over the entire financial sector were imposed by Law 165 of 2005. The FIA is responsible for setting and monitoring compliance with detailed AML/CFT obligations for the financial sector. The CBSM Governing Council, appointed by the Parliament, publishes an Annual Report and maintains banking system data on its web site. It is staffed by professional, competent, and diligent supervisory staff.

62. **San Marino's present banking supervision regime was put in place only recently.** Before the current Law and regulations were introduced, supervision was underdeveloped, with a minimum capital requirement on banks but no minimum capital adequacy ratio. Starting in 2003-2004 the CBSM required banks to calculate regulatory capital and risk weighted assets. The supervision department that preceded the CBSM had only two staff members, one of whom was part time. Little supervisory reporting took place and no inspections were undertaken. Regulations issued in 2007 and enacted in 2008 place greater obligations on the banking sector, but include transitional provisions lasting until 2013 for a number of key requirements, such as the minimum capital asset ratio and the concentration and connected lending limits, and several banks have availed themselves of these transitional provisions. There is insufficient CBSM staff and the CBSM has not yet completed the implementation of its supervisory methodology. The supervisory model and supervision manuals are incomplete and there have been few full inspections of banks. The CBSM's full independence is compromised by the influence of government bodies over its budget and certain core functions, such as licensing.

63. **The banking sector dominates the financial sector.** There are 12 banks, all in the private sector, with total banking assets of €11.5 billion (nine times GDP) as of end-June 2009. The three largest banks hold almost three quarters of banking assets between them. Six banks are foreign owned but only two banks are members of foreign banking groups. Net profit in 2008 was €47m with the nonbank sector contributing €8.3m.[8]

64. **San Marino's banking sector relies heavily on foreign intermediation.** External deposits represent a large share of total deposits, and a large share of banks' assets is placements with Italian banks or foreign securities. A strict bank secrecy regime, favorable taxation, light regulatory burden and free movement of capital—in particular to and from Italy—has made San Marino attractive to foreign depositors. This makes San Marino vulnerable to policy changes in Italy that may affect the propensity of Italian depositors to

[8] Source: CBSM.

use San Marino banks. These risks have increased with an Italian tax amnesty that has resulted in a substantial outflow of deposits and a developing liquidity problem.

65. **The nonbank financial sector consists of about 56 firms, including 52 finance and fiduciary companies, two asset management companies, and two insurance companies.** Asset management and insurance companies have only recently been licensed and hold very few assets at present. Fiduciary and finance companies, most of which are owned by banks, hold more of the assets of the finance sector and employ a third of total staff, having experienced high growth during the past few years.[9] Financial companies provide leasing and factoring services, Fiduciary companies hold customers assets in their own name.

Preconditions for Effective Supervision

66. **San Marino has no independent monetary policy, but rather has a monetary agreement with the Eurosystem EU.** It has little public debt, but the budget is heavily reliant on the financial sector which could face a contraction.

67. **San Marino is almost totally dependent on foreign infrastructures for its own operations, such as payment systems, fund transfers, processing of checks, financial instrument deposits, commercial receipts, credit cards, and cash.** This adds to the vulnerability of the banking system. Communications are good, but skilled labor has been in short supply, given the strict residency policies and the restriction on hiring non resident staff without permission.

68. **San Marino has undertaken substantial economic reforms since 2005 to increase market discipline.** New laws have been introduced to reform the commercial sector. Companies' legislation has been updated and governance requirements strengthened. Tax reform has been undertaken to enhance collection and reduce bureaucracy and new labor laws have been designed to increase flexibility. Reform of the pension sector has reduced liabilities and increased contributions. The financial sector is faced with competition from abroad, particularly Italy.[10]

69. **There is no deposit insurance and the CBSM has limited ability to function as a lender of last resort.** Although the law provides for a deposit insurance system, no such system has yet been developed in San Marino. The CBSM does not issue currency (except for commemorative euro coins issued on rare occasions). The CBSM has a modest lending facility in place, which has been used to provide a € 100 million loan to the largest bank.

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[9] Source: CBSM.

[10] Source: IMF Article IV report 2007

However, given the large size of bank assets relative to the size of the economy, there is limited scope for liquidity assistance.[11]

Main Findings

Principle 1: Objectives, independence, powers, transparency and co-operation.

70. **The CBSM was established by Law no 96 of 2005, which sets out its overall objectives and functions.** The CBSM is responsible for the supervision of the entire financial sector. The supervisory powers and functions of the CBSM are clearly spelt out in Law no 165 of 2005. The CBSM also has a general responsibility for promoting financial stability. The GCCB is appointed by the GGCSM on the basis of a proposal from the CCS. The statute also gives specific responsibility for supervision matters to the SCCB, appointed by the GCCB, with the approval of the CCS. The DGCB is the chief executive of the CBSM and is appointed by the GCCB with the approval of the GGCSM. The GGCSM and the State Congress have roles in the appointment and dismissal of senior management. These complex arrangements undermine full accountability and should be simplified to make the GCCB fully responsible and accountable for the CBSM. This should be subject to changing the GCCB appointment process on the lines of that adopted by other small jurisdictions so that it becomes more open and transparent and addresses conflicts of interest – particularly by encouraging more members from outside San Marino.

71. **The independence of the CBSM does not meet international standards.** The independence of the CBSM is compromised to a considerable degree by the requirement that decisions on licensing and certain other matters are all subject to the ultimate approval of the State Congress. The CCS is given some powers to influence the CBSM in Article 45 of the statute and Article 101 of the Law no 165. The DGCB does not have protection against arbitrary dismissal by the Government. The CBSM relies for over half its income on profits from trading and for most of the rest, on a contract with the Government for certain services which expired in 2008 and has not been renewed. Budgetary uncertainty is increased further because the CBSM funds the activities of the FIA but has no control over its budget. These matters undermine the independence of the CBSM.

Principles 2-5: Licensing and structure.

72. **The law provides the appropriate licensing powers.** The authorization criteria applied by the CBSM are reasonably comprehensive, covering fitness and properness, governance and prudential requirements. They are consistent with the ongoing requirements placed on banks. The CBSM has the necessary powers to enforce these requirements. The CBSM has appropriate powers over the acquisitions of banks and their non banking

[11] Source: CBSM

activities. The main weakness in this area is the influence of the State Congress over licensing decisions, as already noted.

Principles 6-16: Prudential regulations and requirements.

73. **The CBSM imposes a minimum risk weighted capital ratio of 11 percent—higher than the Basel minimum of 8 percent and supplemented by a rule that limits total deposits to 200 times free capital.** There is no capital requirement for market risk or interest rate risk in the banking book. Regulations covering large exposures and related party lending are broadly in line with Basel principles. However, banks are permitted to apply for a transitional arrangement that will allow them to phase in requirements for capital, related party lending and large exposures over five years and up to a third of banking system assets are in banks that have been granted this permission.

74. **There are appropriate provisions for risk management, for large exposures, and for related parties but there are no specific requirements on country and transfer risks and requirements on operational risk are at a high level of generality.** Bank directors are given specific responsibilities in the regulations for risk management. However, the Regulations do not address country and transfer risk. Although the CBSM may regard such risks as limited in the current circumstances, it needs to ensure that there is a sufficient risk monitoring system in place. Operational risk is covered by the requirement to have a risk management policy and by the specific requirement to examine certain kinds of operational risk such as fraud and conflicts of interest

75. **Provisions for liquidity risk have only recently been introduced and provisions for operational risk are at a high level of generality.** A recent circular on liquidity risk has introduced very frequent reporting requirements for banks' liquidity position, analyzed by maturity categories specified by the CBSM. This requirement was introduced in 2009 and its effectiveness cannot yet be assessed, although the requirements appear to be appropriate.

Principle 18: Abuse of Financial Services

76. **The authorities have introduced a substantial body of law and regulations governing the prevention of money laundering and terrorist financing. Prior to 2008, AML/CFT requirements were not effectively enforced.** The current law and regulations governing the obligations on banks are broadly appropriate. The law and subsequent instructions are clearly written with a view to matching the international standard. Banks, in some cases at least, have begun to put effective internal programs in place. The risks arise from the legacy of customers taken on before the current regime was in place. The CBSM and FIA are addressing this by requiring risk assessments of existing customers but it is not easy to acquire the relevant information to make such assessments retrospectively. A particular problem arises as a result of the activities of fiduciaries under the old regulations whose activities involved providing nominee facilities for customers who sometimes

deposited their funds in cash or in other ways that made tracing the provenance difficult. Fiduciaries place their funds with banks and this can transfer some of the risks to banks.

77. **The CBSM and FIA should coordinate their enforcement.** Both FIA and CBSM have responsibilities for enforcing compliance with AML/CFT obligations and they have signed an MoU. There is some sharing of information but their effectiveness could be enhanced by coordinating their enforcement efforts through a jointly planned risk-based approach. There is also a need for additional resources for monitoring compliance with AML/CFT obligations.

Principles 17 and 19-23: Supervisory Methods and Approach

78. **The CBSM has most of the necessary supervisory tools at its disposal but does not have sufficient resources fully to undertake its supervisory role.** The CBSM has broad and sufficient powers to set, monitor and enforce standards. They have implemented a reporting regime for banks which provides information that can be used to analyze banks' performance. The CBSM, however, was only able to conduct two full scope inspections of a bank since 2006, although it conducts other more specific inspections, primarily related to credit risk and has conducted 11 inspections of non bank financial institutions. The CBSM does not have a formal supervisory model (such as CAMEL) and has not completed its supervisory manuals. It has been distracted from its task by ad hoc requests for judicial investigations and by the pressing need to deal with the difficulties facing the banking system in 2009.

79. **The CBSM should address governance issues in banks.** The Regulations require the Board of Directors to ensure that there are proper internal controls. However, the CBSM has noted a weakness in corporate governance in Sammarinese banks arising from over delegation. The CBSM can increase its efforts to educate Boards of Directors but should also have the power to remove Boards of Directors as one of its sanctions (albeit subject to appeal).

Principles 24 and 25: Consolidation and cross border issues

80. **The CBSM does not undertake consolidated supervision and the law could inhibit consolidated supervision by foreign supervisors.** The CBSM is proposing to introduce comprehensive rules on consolidated supervision in due course but points out that the risks arising from the absence of consolidated supervision are relatively small as only one Sammarinese bank has a foreign subsidiary and domestic subsidiaries are under the direct supervisory responsibility of the CBSM. For foreign owned banks, the CBSM very properly ensures that the foreign supervisor includes the San Marino bank in its consolidated supervision. However, Article 42 (which gives only the CBSM the right of on-site inspection) and the secrecy provisions in Article 36 of Law no 165 that prevent disclosure of confidential information by a bank to anyone except the judicial criminal authorities and the CBSM, appear to prevent on-site inspections by foreign supervisors. Moreover, the foreign

owned banks report that they do not report confidential customer information to their parent companies and do not permit their head office internal audit or compliance staff access to their files. This is consistent with the prohibition on disclosure in Article 36 of Law 165.

81. **The scope for cooperation with foreign authorities is too constrained.** The combination of the secrecy and international cooperation provisions in the law will place unnecessary barriers in the way of effective and rapid international cooperation. These barriers include the need for prior agreements to be in place (which can be time consuming) and that there be an assessment of the equivalence of the foreign confidentiality regime. Written permission prior to any onward disclosure would prevent many foreign supervisors from accepting information because of compulsory domestic disclosure requirements. These provisions need to be simplified to allow full and rapid cooperation that the CBSM wishes to offer.

Table 3. Summary Compliance with the Basel Core Principles

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	Responsibilities clearly stated.
1.2 Independence, accountability and transparency	Accountability undermined by complex appointment, responsibilities, and reporting lines. Independence compromised by involvement of government in key decisions and in budget. Budgetary resources constrained particularly by burden of judicial investigations.
1.3 Legal framework	Recently introduced and up to date.
1.4 Legal powers	All powers necessary are provided to the CBSM
1.5 Legal protection	Most legal protections provided but the DGCM does not have protection against arbitrary dismissal and there is no explicit provision for paying for staff defenses against legal action.
1.6 Cooperation	Domestic cooperation works reasonably well with full exchange of information possible with the FIA (but enhancements possible as noted in Principle 18)
2. Permissible activities	Only banks can accept deposits. Bank activities properly regulated.
3. Licensing criteria	Licensing criteria reasonably comprehensive, although some gaps relating to regulatory disciplinary history of corporate officers. Role of Government in licensing compromises the integrity of the process.
4. Transfer of significant ownership	The CBSM has the powers it needs to control ownership but does not yet ask for periodic reporting of ownership.
5. Major acquisitions	CBSM can control major acquisitions and the transitional regime ends in 2010

6. Capital adequacy	Regulations impose Basel I requirements except for market and banking book interest rate risk. Some banks have been allowed to postpone full implementation of capital adequacy until 2013.
7. Risk management process	Banks have risk management requirements imposed upon them but some strengthening is required; e.g. need to increase directors' involvement and understanding
8. Credit risk	Credit risk policy requirements are comprehensive.
9. Problem assets, provisions, and reserves	Loan loss provisioning requirements recently introduced and effects will be seen for the first time in 2009 balance sheets when submitted.
10. Large exposure limits	Large exposure limits are in place but some banks have adopted the transitional measures which postpone full implementation until 2013.
11. Exposure to related parties	Related party exposure limits are in place but some banks have adopted the transitional measures which postpone full implementation until 2013.
12. Country and transfer risks	There are no specific requirements on these risks, largely because there are few such risks in a system that has few exposures outside Italy and San Marino itself.
13. Market risks	Apart from the adoption of a minimum capital adequacy ratio above the Basel I minimum, there is no capital provision for market risk.
14. Liquidity risk	Regulations are on the right lines but only recently introduced. CBSM will need to focus on ensuring implementation.
15. Operational risk	Operational risk requirements are at a high level of generality and a Basel II style framework is being introduced.
16. Interest rate risk in the banking book	There are no explicit capital provisions for interest rate risk in the banking book and this is being introduced.
17. Internal control and audit	The requirements are generally comprehensive but gaps remain in the reporting arrangements for compliance officers and the ability to remove Directors.
18. Abuse of financial services	A new regime is being introduced but risks remain from the legacy of past practice and the limited staff available for enforcement in FIA and CBSM. Better coordination between FIA and CBSM will enhance effectiveness.
19. Supervisory approach	No formal methodology but CBSM shows good understanding of the risks facing the banks.
20. Supervisory techniques	Limited staff and distraction by other duties has limited the number of full bank inspections. Supervisory manuals are not yet complete.
21. Supervisory reporting	The regime is relatively new but appears to be comprehensive and provides the CBSM with the data it needs for risk analysis.
22. Accounting and disclosure	IFRS not yet fully introduced but the CBSM accounting regulation is broadly compatible.

23. Corrective and remedial powers of supervisors	Supervisors have full powers but there is an involvement by the Government in some winding up decisions and there is no power for the CBSM to remove banks Board members when they cease to be fit and proper.
24. Consolidated supervision	There are as yet no comprehensive provisions for consolidated supervision.
25. Home-host relationships	Secrecy provisions inhibit cooperation, prevent proper risk management in foreign owned banks by limiting information flows and are a barrier to consolidated supervision by foreign supervisors who cannot undertake on-site inspections.

Recommended Action Plan and Authorities' Response

Table 4. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Core Principle	Recommended Action
1. Objectives, autonomy, powers, and resources	
1.2 Independence, Accountability & Transparency	• Role of State Congress in licensing or extraordinary administration and compulsory liquidation should be removed • Clarify that the CCS can only give broad objectives • The DGCB should have protection against arbitrary dismissal • The budget process should be reformed to give greater certainty to the CBSM, enhance resources and, in particular, cover the cost of judicial investigations • The nomination process for the GCCB should be more open and transparent • The DGCB should be a full member of the GCCB • Clarify accountability of GCCB and remove reference to SCCB in the Statute
3. Licensing criteria	• The criteria for "good repute" should include the absence of disciplinary action by any regulatory or professional body and the information supplied by an applicant should include details of all investigations by such bodies.
4. Transfer of significant ownership	• There should be periodic reporting of bank ownership on an annual basis • Banks should be required to report any material information relating to the fitness and properness of a bank's owners or beneficial owners. • The CBSM should publish criteria showing how it would judge if a bank application was incompatible with the structure and needs of the domestic market.
5. Major acquisitions	• The CBSM should consider adding a further criterion reflecting the quality of supervision in the host country of a foreign acquisition.

6. Capital adequacy	• The CBSM should set a timetable for the move to a standardized approach under Basel II • The CBSM should keep under review the objective of shortening the transitional period for full compliance with the Capital Adequacy Requirement
7. Risk management process	• Corporate governance regulation should be strengthened to require an assessment of risks and controls on a regular basis by the Board, to require Boards to approve new products that affect the risk profile, to insist that internal audit cover the risk management system, to train staff in risk management and to conduct stress tests
8. Credit risk	• The CBSM should strengthen the provisions relating to the evaluation of the credit risk policy and the importance of monitoring and reporting of borrowers, collateral, economic circumstances affecting borrowers or groups of borrowers, total indebtedness of borrowers, limits on particular borrowers or sectors and implementation of those limits.
10. Large exposure limits	• The CBSM should keep under review the objective of shorting the transitional period for achieving full compliance with the regulation on large exposures. • Banks should be required to set thresholds for concentration risk in respect of geographic or economic sectors and to make a regular report to their Boards on concentration risk.
11. Exposures to related parties	• Related parties should explicitly include close family members of owners and directors of the banks and subsidiaries. • Persons benefitting from related party transactions should not be present when decisions about the transaction are made. • Monitoring and reporting requirements should be strengthened, with all exceptions to the bank policy reported to the Board • The CBSM should keep under review the objective of shortening the transitional period for achieving full compliance with the Regulation on related parties' exposures.
12. Country risk	• Banks should be required to manage country risk
13. Market risk	• The CBSM should make early progress with the introduction a capital charge for market risk
14.Liquidity risk	• The CBSM should strengthen banks' liquidity management
15. Operational risk	• The Regulations should encompass a broader operational risk framework • The CBSM should move towards introducing a capital charge for operational risk on the lines of Basel II
16. Interest rate risk in the banking book	• New Regulations as proposed by the CBSM should be introduced.
17. Internal control and audit	• Banks should have an explicit requirement to safeguard assets and liabilities. • Internal audit should have a proper plan and methodology.

18. Abuse of financial services	• Require a bank to have a customer acceptance policy; • Strengthen the simplified due diligence procedures so that they state what due diligence is required; • Limit the use of third party introductions and simplified due diligence to cases where the bank itself has undertaken an analysis of the due diligence processes of the introducer and is satisfied; • Require senior management approval to continue with an account when a person becomes a PEP or is found to be one after they have been accepted as a customer; • Limit the transactions that can be undertaken in advance of the completion of due diligence or otherwise require management of risks. • Resolve conflict between primary law requirement for ongoing monitoring and FIA Instruction that allows periodic reviews at intervals of up to two years. • Introduce requirements for the adequate screening of staff for high ethical standards. • Expand the exemptions from bank secrecy in Article 36 to allow disclosure to the relevant law enforcement authority of any matter that gave rise to a knowledge of financial crime other than ML or TF. • Add to the resources available for enforcement • CBSM and FIA to plan their enforcement action jointly • CBSM and FIA to issue guidance that customers who came to the bank with cash or endorsed checks over a threshold should be regarded as high risk and treated accordingly • CBSM to consider prohibiting the use of omnibus accounts from fiduciaries especially where there is evidence of inadequate due diligence.
19. Supervisory approach	• The CBSM should introduce a formal methodology for supervision
20. Supervisory techniques	• The CBSM should make a first round of inspections with external support to assess the risks of the banks • The CBSM should make a full assessment of the staff resources it needs to form the basis of its budget and recruitment plan • The CBSM should finalize its supervision manuals.
21. Supervisory reporting	• The CBSM should introduce consolidated reporting
22. Accounting and disclosure	• The CBSM should monitor the use of the permission to depart from the Regulation on accounting standards. • The CBSM should introduce IFRS when possible. • CBSM should consider requiring auditor rotation.
23. Corrective and remedial powers	• The CBSM should be able to remove individual corporate officers when no longer fit and proper.
24. Consolidated supervision	• The CBSM should adopt comprehensive consolidated supervision when priorities allow.

25. Home host relationships	• The requirement that foreign supervisors' confidentiality protection should be at least equivalent to that in San Marino should be changed so that it is required to be "adequate." • Remove requirement that any foreign recipient of confidential information from CBSM must give an undertaking not to disclose that information to a third party without written permission of the CBSM. Remove the requirement for an agreement prior to information exchange. • Amend Law 165 to allow a foreign owned bank to pass information to its parent bank and its home state supervisor • Amend Law 165 to allow foreign supervisors to conduct on-site visits in San Marino of subsidiaries of foreign owned banks.

Authorities' Response to the Assessment

82. **The authorities commented particularly on the assessments related to cooperation and to AML/CFT.** On cooperation, the authorities consider that Law 165 permits foreign on-site visits of foreign owned banks in San Marino, where there is a cooperation agreement in place, especially when the foreign supervisor was accompanied by the CBSM. They thought it right that the CBSM should sign more MoUs with foreign supervisors and considered that the agreement between the Sammarinese and Italian Government should pave the way for a MoU between CBSM and BdI. Moreover, the authorities considered that, in the context of an MoU the time taken to make an assessment of equivalent confidentiality protection was not unduly burdensome. The authorities further considered that the Regulation allowing foreign owned banks to provide information to their parent banks was fully compliant with the prohibition on disclosure of confidential information in Article 36 Regarding the prevention of money laundering and terrorist financing, the authorities referred to the MONEYVAL report and stated that bearer passbooks did not hide identity but simply the transferability between persons. They questioned whether the mission had demonstrated that the current AML/CFT regulatory regime was less than fully enforced. The authorities pointed out that fiduciary companies were expected to know the beneficial owner of assets deposited with them

83. **The CBSM emphasized the disruptive effect of judicially inspired investigations.** Such investigations have taken up a third of on-site inspection resources in 2009 and this may rise to 50 per cent in 2010.

84. **Current regulations limiting total deposits to a multiple of free capital and plans to meet the EU acquis by 2013 were considered by the authorities sufficient to justify a more favorable rating for Principle 6 on capital adequacy.** The authorities drew attention to the rule that limits total direct and indirect deposits to 200 times free capital (the surplus of actual over minimum capital) and considered that this mitigated the effect of the weaknesses to which the assessment drew attention, especially when plans to meet the EU acquis on prudential matters by 2013 were taken into account.

85. **The authorities drew attention to current developments.** They noted that they were currently negotiating a monetary agreement with the EU that would involve adopting the EU acquis relevant to the financial sector in full by 2015 and the prudential Directives by 2013 (which would include the extension of the Basel II framework to their banks). They also noted that they had introduced a new provision designed to strengthen liquidity management in banks. This introduced a reserve requirement for all banks equal to 8 per cent of direct deposits.

APPENDIX: STRESS TESTING METHODOLOGY

A. Data and Design of Tests

86. **Tests were conducted to determine the levels of stress that would correspond to particular negative outcomes.** Rather than selecting and testing particular scenarios, the tests examined wide ranges of possibilities to identify the precise level of stress that would cause certain thresholds (e.g. half of the assets of the banking system to be in undercapitalized banks) to be met.

87. **Banks' capital was adjusted for the baseline stress testing scenarios.** Banks' holdings of untraded equities were revalued as of end-June 30, 2009 based on recent independent analysis. This lowered the average risk-weighted CAR ratio of the banking sector from the officially reported 15.4 percent to 11.0 percent.

88. **Tests were conducted on deposit outflows.** Two forms of losses were considered. The first is fire sale losses: losses due to the liquidation of assets at below market prices. The second type of loss is an income loss due to the loss in revenue. The tests assumed a uniform outflow of customer deposits, deposits by banks, and securities. This simplification slightly underestimates the income lost to banks since the first deposits to flow out would be demand deposits, which are the least expensive form of financing to banks and would therefore hurt the most to lose. Income data were not available divided into demand deposits and time deposits, so no estimation of the differences in cost between these two types of deposits was possible, a useful refinement that might have had a noticeable impact on the results.

89. **For the deposit outflow tests assumptions needed to be made regarding the fire sale value of assets and the duration of the income loss.** A range of fire sale asset values was discussed with the central bank, taking into account that these estimates were subject to significant uncertainty, and tests were performed with more than one set of values and the values are noted in the test results. It was assumed that deposits with banks would most likely sell at the lowest discount, followed by securities and finally customer loans. It therefore followed that when banks had to cover deposit outflows they would first withdraw deposits with other banks, then sell securities, and lastly they would sell customer loans if necessary.

90. **A second set of deposit outflow tests was performed in which different categories of deposits exited San Marino at different rates (Appendix Box 1).** These tests could only be performed on the system in aggregate because detailed data on the different types of deposits was not available bank by bank. They assumed that deposits with the CRSM would leave San Marino at the highest rate, followed by foreign deposits at other banks and then by domestic deposits at other banks.

91. **Lost interest income and reduced interest expenditures on various categories of assets and liabilities were assumed to be proportional to outflows.** If half of demand deposits left San Marino interest paid to demand depositors was assumed to decline by half.

Reductions in commission income were assumed to be proportional to the reductions in net interest income. In order to determine the impact on capital of a loss of income it was necessary to choose a time frame for the income loss. The stress tests on interest rate changes considered the effect on capital of one year of lost income, while the tests on deposit outflows considered the immediate impact of the outflows before any effect from lost income.

92. **The NPL tests examined different losses of customer loans, deposits with other banks, and securities.** These three categories of assets account for about 90 percent of banks' total assets, with the rest being made up of fixed assets, accruals, and some equity investments, mostly in group companies.

93. **Tests on a deterioration of customer loans examined different percentages of complete losses net of any recovery on good loans.** The same percentage times three (up to a maximum of 100 percent) were applied to substandard loans so that a shock that would cause a 1 percent loss in good loans would also cause a three percent loss of substandard loans. This ratio was agreed with the CBSM. It should be noted that the average recovery on bad loans was 58 percent in 2008, meaning that a stress test loss of 10 percent would correspond to over 20 percent of all loans failing to be repaid. (Similarly it could correspond to 50 percent of loans requiring 20 percent provisioning, or any other scenario that results in a reduction of capital equal to 10 percent of good loans to customers.)

94. **Detailed data on categories of loan quality divided loans into good, substandard, and write-offs.** The data on NPLs (substandard and write-offs) are only collected annually and therefore were not available for end-June 2009. But these amounts are small compared to total loans and are estimated to have been moderately stable, so end-2008 figures were used for the end-June 2009 tests.

95. **Percentage deteriorations were also applied to loans to banks and to securities.** Again, the percentage losses are total losses that would need to be deducted from capital. A 10 percent loss could correspond to a 10 percent decline in the value of the total portfolio of securities plus bank deposits, or it could represent a failure of a single bank holding 10 percent of the value of the portfolio.

96. **Extensions of the basic stress tests on nonperforming loans included examining an increase in NPLs of large borrowers and of loans to particular sectors.** These tests did not take existing substandard loans into account because no breakdown of substandard loans by large borrower or by sector was available. Different percentages of performing loans to particular sectors or to various numbers of the largest borrowers were assumed to be written off completely.

97. **Tests on loan concentration examined the vulnerability of individual banks to large borrowers and connected groups of borrowers.** In these tests the loans to the largest single borrower or connected group of each banks loses value at the same time, an unlikely

scenario that should be viewed as a simultaneous test of all banks individually rather than a test of the system. Scenarios where several banks are severely impacted by declines in the value of large loans should be interpreted as a summary of separate tests showing individual banks' vulnerabilities rather than a threat that the whole system could be in difficulty at the same time. It should be taken into account that if a single bank finds itself in difficulty because a large borrower defaults it would be much easier to support that bank than if several banks were in difficulty at the same time. On the other hand, it should also be noted that large borrower of various banks could get into difficulty simultaneously in the event of an economic downturn, and that one large borrower could represent the largest exposure at more than one bank.

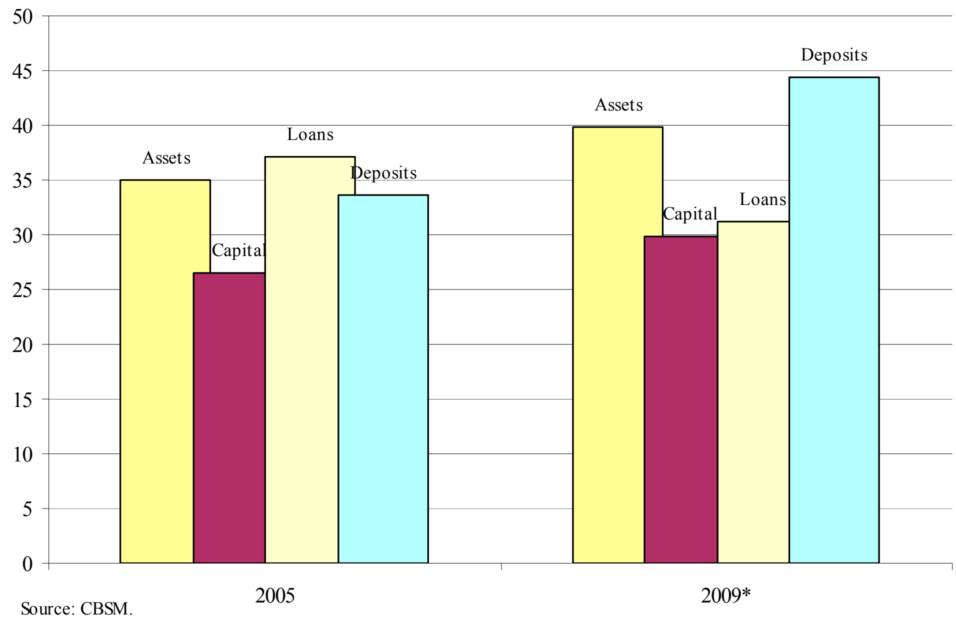
98. **Stress tests on interest rate changes examined effects on banks' net interest incomes.** The average interest rate spread on interest earning assets and liabilities in San Marino is 1.8 percent. An average 90 basis point increase in the cost of funds as a result of factors that reduce the attractiveness of bringing money to San Marino would therefore reduce net interest income by half. Movements in interest rates would affect banks' incomes and would eventually affect their ability to maintain their capital stocks. The stress tests assumed that in the absence of stresses banks' CAR ratios and main aggregates would have remained unchanged.[12] The tests then considered the impact of one year reductions in net interest income and the change in capital that would result. The one-year time frame is arbitrary and over longer periods the impact would be greater. Reductions in spreads are likely to reflect increases in the costs of funds caused by San Marino losing its banking secrecy and relaxed regulation advantages. Decreases in interest rates on interest earnings are less likely because these rates are already so low that there is little room for them to decrease.

99. **The importance of off-balance sheet items was tested.** Off-balance sheet items include guarantees and loan commitments. Guarantees can be invoked when a borrower defaults, resulting in a need to add provisioning. Commitments can be drawn suddenly and then defaulted on. Borrowers who are in trouble are likely to draw on available commitments before their difficulties become known as they try to avoid default. The tests employed the common practice of applying a 50 percent weight to off-balance sheet items. Thus a test in which 10 percent of all loans were written off would also include a write-off of 5 percent of off-balance sheet items.

[12] The assumption that CARs would not change is plausible, but it is an oversimplification to assume that banks would not grow over the course of a year. Any growth would slightly mitigate the negative effects of any stress as the reduction in capital would be spread over a slightly larger stock of risk-weighted assets. The difference is unlikely to be large enough, however, to merit the increased complexity that would be needed to reflect it.

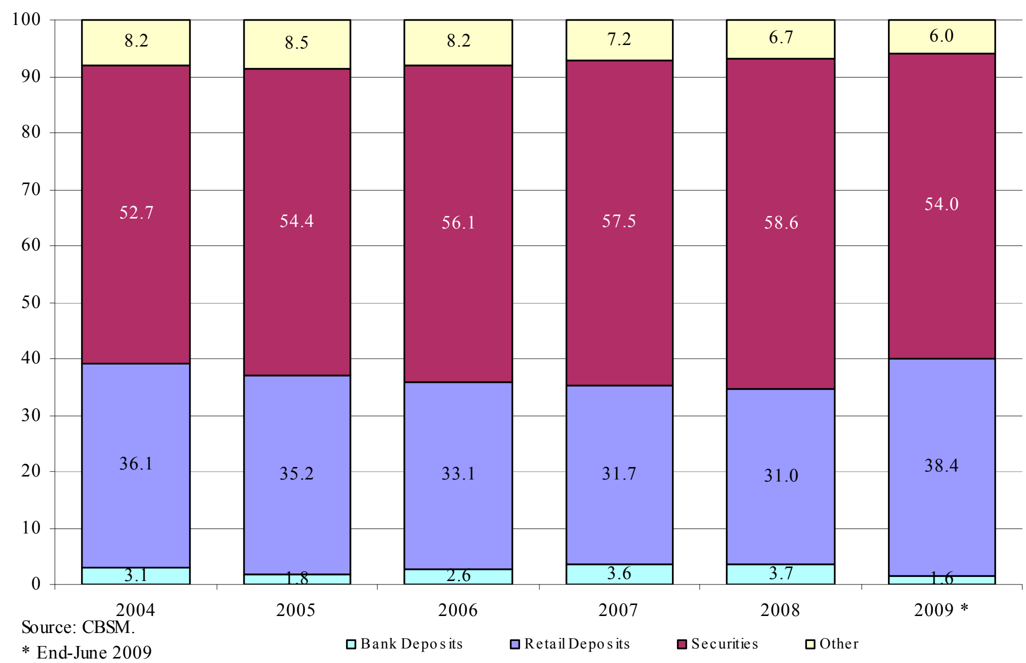
Statistical Appendix

Figure 1. San Marino: Foreign Banks' Market Share
(in percent)



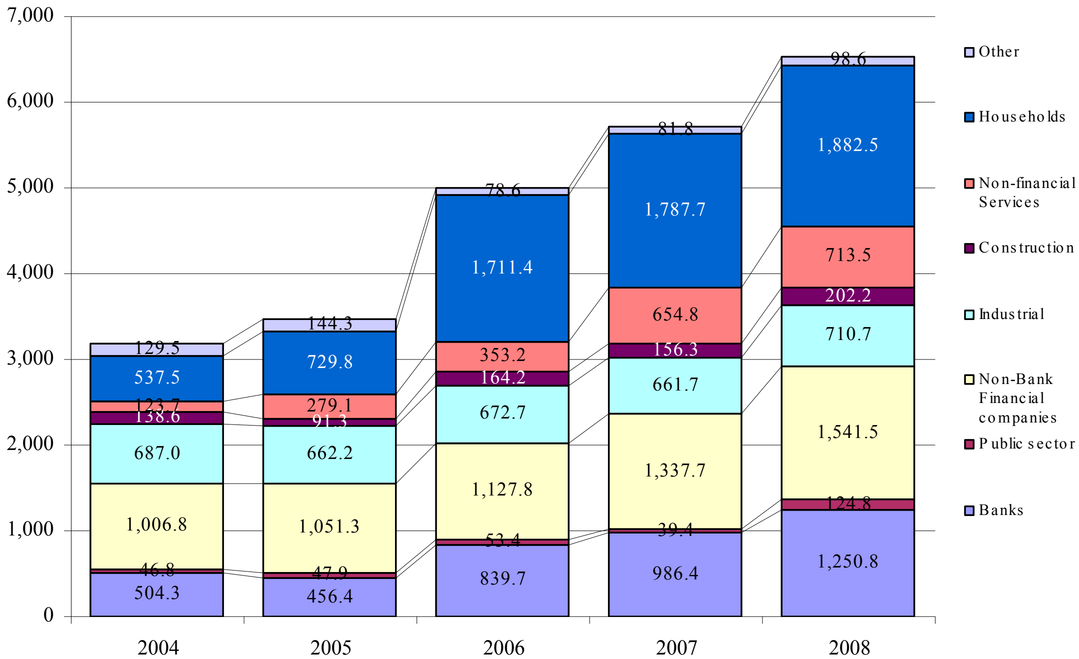
Source: CBSM.
* End-June 2009

Figure 2. San Marino: Banks Funding Sources
(end-period, percent of liabilities)



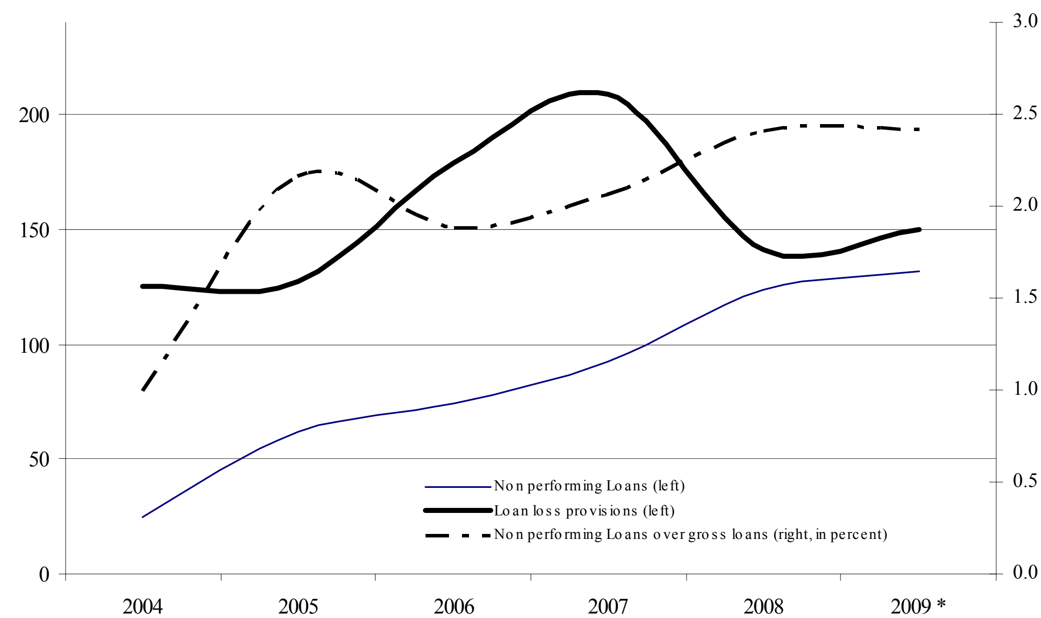
Source: CBSM.
* End-June 2009

Figure 3. San Marino: Sectoral Distribution of Loans
(End-period, euro millions)



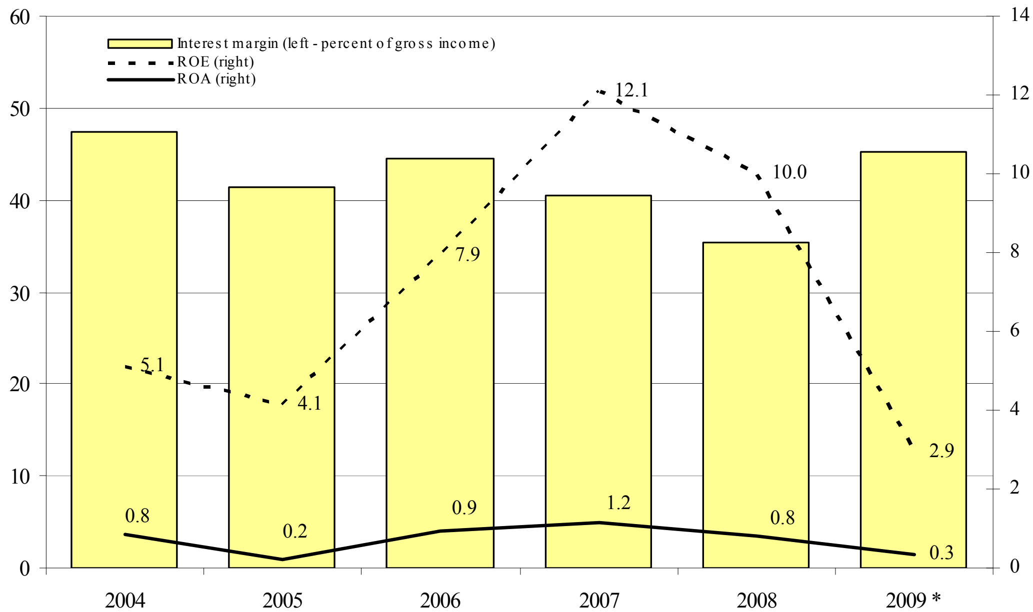
Source: CBSM

Figure 4. San Marino: Banks Nonperforming Loans
(End-period, in euro millions unless otherwise indicated)



Source: CBSM.
* End-June 2009

Figure 5. San Marino: Bank Profitability
(End-period, except where noted)



Source: CBSM.
* End-June 2009

Appendix Table 1. San Marino: Selected Economic Indicators

(Percent unless otherwise indicated)

	2004	2005	2006	2007	2008	Latest Reading		Projections 2009	2010
Selected Economic Indicators									
(Annual percentage change, unless indicated otherwise)									
Output and prices									
Real GDP	4.6	2.4	3.8	3.5	-1.1			-5.0	-1.8
Employment	2.8	1.2	1.7	3.2	3.5	-1.2	Nov-09	-1.5	-0.7
Unemployment rate (end of year; percent)	3.4	3.6	3.3	3.0	3.1	4.7	Nov-09	5.1	5.5
Inflation rate (average)	1.4	1.7	2.1	2.5	4.3	1.8	Nov-09	2.4	2.7
Nominal GDP (millions of euros)	1061.4	1105.7	1170.9	1232.8	1259.0			1214.0	1214.5
(Percent of GDP)									
Central government									
Overall balance	1.2	4.3	1.8	5.4	0.0			-4.3	-3.5
Primary balance	1.5	4.5	2.0	5.7	0.3			-4.1	-3.2
Gross debt	4.5	5.8	5.1	4.3	4.2	4.4	Jun-09	4.4	5.3
(Percent of GDP, end of period)									
Net foreign assets									
Deposit money banks	61.15	72.12	18.16	22.23	3.07	…			
Central bank	24.54	27.14	31.07	35.69	39.16	…			
(Percent of GDP, unless indicated otherwise)									
External accounts									
Trade balance 1/	-4.1	-3.7	-0.3	2.4	15.7	…		17	20
Exports 1/	186.1	184.0	197.0	202.1	222.5	...		215	220
Imports 1/	190.2	187.7	197.3	199.6	206.8	...		198	200
Gross international reserves (millions of USD)	355.6	354.0	479.1	647.8	706.8	…			
Social Indicators									
Land area (2008)	23.5 sq mi								
Population, total (2008)	29,973								
Life expectancy at birth, total (2006)	82.2								
Life expectancy at birth, male (2006)	79.4								
Life expectancy at birth, female (2006)	85.1								
Infant mortality rate per 1,000 live births (2007)	3.5								
Population per sq. km of land area (2008)	1,225/sq mi								

Sources: Sammarinese authorities; Fitch Ratings; World Bank; and IMF staff estimates.

1/ Based on national account data.

Appendix Table 2. San Marino: Financial System Structure, 2003-2009

	2003	2004	2005	2006	2007	2008	2009 [1]
Number							
Banks	10	11	12	12	12	12	12
o/w foreign-majority owned	6	7	8	7	6	6	6
Insurance companies (life)	0	0	0	0	0	0	2
CIS/management companies	0	0	0	0	5	9	11
Financial system assets (in millions of euros)							
Banks	6,397	7,155	7,723	8,976	10,415	11,536	11,697
o/w foreign-majority owned	2,268	2,625	3,154	3,218	3,798	4,414	4,650
Insurance sector	0	0	0	0	0	0	25
CIS/management companies	0	0	0	0	38	37	39
Total financial system assets 2	6,397	7,155	7,723	8,976	10,453	11,573	11,761
Assets as percent of total financial system							
Banks	100	100	100	100	99.6	99.7	99.5
o/w foreign-majority owned	35.4	36.7	40.8	35.9	36.3	38.1	39.5
Other non-bank institutions	0	0	0	0	0.4	0.3	0.5
Assets as percent of GDP							
Banks	...	...	698	767	853	871	...
o/w foreign-majority owned	...	...	285	275	311	333	...
Other non-bank institutions	...	...	0	0	0.03	0.024	...

Source: BCSM.

1. As of June 2009
2. Figures do not include data on other nonbank financial institutions like fiduciaries, leasing, and factoring companies.

Appendix Table 3. San Marino: Financial Soundness Indicators, 2004-09

	2004	2005	2006	2007	2008	2009 1/
Capital adequacy ratios (percent)						
Regulatory capital to risk-weighted assets	22.8	23.1	18.9	17.5	16.9	11.0 6/
Asset quality ratios (percent)						
Nonperforming loans to total loans	1.0	2.2	1.9	2.1	2.4	2.4
Provisioning to total loans	5.0	4.4	4.5	4.7	2.7	2.8
Provisioning to total NPLs	499.6	205.5	240.2	226.7	113.8	113.7
Earning and profitability (percent)						
Return On Assets (ROA)	0.8	0.2	0.9	1.2	0.8	0.3
Return On Equity (ROE) 2/	6.7	2.0	8.4	10.7	7.6	3.1
Return On Equity (ROE) 3/	5.1	4.1	7.9	12.1	10.0	2.9
Interest margin to gross income	48.2	47.8	46.9	43.9	43.5	44.3
Non-interest expenses to gross income	23.1	22.9	20.9	18.3	17.7	20.5
Salary expenditures to non-interest expenditures	89.1	89.9	89.9	91.5	92.1	94.2
Liquidity (percent)						
Liquid assets to total assets 4/	53.5	51.0	42.5	41.9	42.0	41.3
Liquid assets to short-term liabilities 5/	78.9	90.4	90.3	96.3	103.5	97.9

Source: CBSM, IMF staff estimates

1/ As of June.
2/ Before extraordinary items and taxes.
3/ After extraordinary items and taxes.
4/ Liquid assets include cash in vault, loans to banks on demand and securities.
5/ Short term liabilities include due to banks and customers on demand, and repos.
6/ Official data indicate that the average risk-weighted CAR of the system was 15.4 percent as of end-June 2009. However, adjustments made by the FSAP team bring that figure down to 11.0 percent. These adjustments were based on the results of independent assessments made after the FSAP mission that addressed the value of banks' holdings of untraded equity.

Appendix Table 4. San Marino: Consolidated Balance Sheet of Banking Sector

(as of June 30, 2009- in euro millions)

	Total	Domestic	Foreign
ASSETS			
Cash and other values	49	33	17
Loans to banks	1,067	588	478
a) on demand	774	360	414
b) other loans	293	229	64
Loans to customers	5,433	3,880	1,553
- loans loss provisions not taxed	-166	-107	-58
Bond portfolio and other debt securities	3,920	1,833	2,087
a) issued by public entities	84	37	46
b) issued by banks	3,219	1,323	1,896
c) issued by other financial entities	487	413	74
d) issued by other entities	129	59	70
Shares, interests and other equity securities	72	60	12
Equity investments	173	144	29
Other Assets	785	376	409
TOTAL ASSETS	**11,498**	**6,913**	**4,585**
LIABILITIES			
Due to banks:	164	143	22
a) on demand	52	39	13
b) on term or with notice	113	104	8
Due to customers :	3,903	2,116	1,787
a) on demand	3,631	2,060	1,571
b) on term or with notice	272	57	216
Debt Securities:	5,496	3,335	2,161
a) bonds	660	487	173
b) certificates of deposit	3,659	2,652	1,006
c) repos	1,164	190	975
d) checks in circulation	13	6	7
Other liabilities	564	317	246
Accruals and Deferred income :	43	30	13
a) Accrued expenses	42	29	13
b) Deferred Income	1	1	1
Retirement allowance	2	0	2
Funds for risk and charges:	171	156	15
a) post-retirement benefit obligations	23	23	0
b) tax liabilities	16	4	12
c) other provisions	132	130	3
Reserve for possible loans losses	28	28	0
TOTAL LIABILITIES	**10,372**	**6,126**	**4,247**
CAPITAL			
Fund for general banking risks	140	137	4
Share Capital	678	524	154
Share premium	12	2	10
Reserves:	269	120	149
a) ordinary reserve	136	41	95
b) extraordinary reserve	104	51	53
c) other reserves	29	28	1
Retained earnings (losses)	-5	-5	0
Net Profit or Loss	31	10	22
TOTAL CAPITAL	**1,126**	**787**	**338**

Source: CBSM.

Appendix Table 5. San Marino: Consolidated Off- Balance Sheet Activity of Banking Sector

(as of June 30, 2009- in euro millions)

	Total	Domestic	Foreign
Guarantees Given	560	449	111
Commitments :	1,856	400	1,456
a) sales and repurchase agreements	1,173	191	982
b) foreign exchange and securities receivable	252	50	203
c) foreign exchange and securities to be delivered	212	55	157
d) other commitments	219	105	115
Assets under management	585	198	387
Custody and administration of securities	13,854	8,157	5,697
a) Third party securities on deposit	6,712	4,629	2,084
b) Third party securities deposited with third parties	3,105	1,484	1,621
c) Proprietary securities deposited with third parties	4,037	2,044	1,992

Source: CBSM

Appendix Table 6. San Marino: Consolidated Income Statement of Banking Sector

(as of June 30, 2009- in euro millions)

	Total	Domestic	Foreign
Interest income and similar revenues:	188	110	78
a) on loans to banks	9	5	4
b) on loans to customers	106	69	37
c) on Treasury Bills and bonds	72	36	36
Interest expense and similar charges:	-85	-48	-37
a) on amounts due to banks	-1	-1	0
b) on amounts due to customers	-63	-43	-20
c) on debt securities (repos)	-21	-5	-17
Dividends and other revenues :	1	0	1
a) on shares, interests and other equity securities	0	0	0
b) on equity investments	0	0	0
c) on equity investments in group companies	1	0	1
Commission income	23	13	10
Commission expense	-3	-1	-1
Trading profit (loss)	10	7	4
Other Operating Income	3	1	2
Other operating expenses	0	0	0
Administrative Costs:	-44	-25	-19
b) Other administrative costs	-19	-12	-8
Writedowns of intangible and tangible fixed assets	-5	-2	-3
Provisions for risks and charges	-114	-114	0
Writedowns of loans and provisions for guarantees	-33	-24	-9
Write-backs to loans and provisions for guarantees	0	0	0
Provisions to loan loss reserves	0	0	0
Writedowns of financial investments	-16	-16	0
Write-backs of financial investments	0	0	0
Profit before extraordinary items and income tax	-75	-101	26
Extraordinary income	1	0	0
Extraordinary charge	-5	-5	0
Extraordinary Profit (Loss)	-4	-4	0
Change in the fund for general banking risks	116	116	0
Income tax for the year	-5	-1	-4
Net Profit (Loss)	31	10	22

Source: CBSM.

Appendix Table 7. San Marino: Comparison with Selected Financial Centers

	San Marino	Monaco [1]	Jersey [2]	Isle of Man [1]	Liechtenstein [3]
Euro Memberships	not a EU member. Customs union with EU.	not a EU member - Customs/financial union with France	not a full EU member, but included in customs territory of EC. Not part of UK, but in a monetray union.	not a full EU member, but included in customs territory of EC. Not part of UK, but in a monetray union.	Liechtenstein participates in a customs and monetary union with Switzerland, and is a member of the European Economic Area
Currency	Euro (by special arrangement with Council of European Union)	Euro (by special arrangement with Council of European Union)	GBP	GBP	Swiss Franc
Structure of Financial Sector					
Asset Size	11.8 billion euro	38 billion euro (assets under management=78 billion euro)	321 GBP billion	140 GBP billion	48 billion CHF (assets under management=173 billion CHF)
Depth (Assets/GDP)	about 9x	about 10x	about 80x	about 37x	about 10x
Contribution to GDP	around 20%	...	54%	39%	around 30%
Number of Banks	12	25	47	44	16
Number of Insurance co.	2	31	12	172	17
Number of other non-bank	~50	~100	~230	~1000	~250
Bank Concentration	High (Top 2 banks > 50% of assets)	Somewhat High (Top 5 banks > 50% assets)	Somewhat Low	Somewhat Low	High (Top 3 banks > 90% of assets)
Bank Ownership	Largely Independent (no parent bank, but some banks have affiliations with Italian groups)	Branches and subsidiaries of larger, global banks	Branches and subsidiaries of larger, global banks	Branches and subsidiaries of larger, global banks	Branches and subsidiaries of larger, global banks
Main lines of business	Collecting Italian deposits and placing them in Italian financial companies and securities.	Private banking and asset management to mainly non-residents.	Collecting retail deposits from non-residents. Wealth and fund management services.	Collecting retail deposits from non-residents - residential motrgages UK	Wealth management/private banking services
Supervisory Architecture					
Supervision authority	Sole supervisory authority - CBSM	Subject to French banking law and supervision - CCAF for nonbank sector	JFSC - integrated regulator	FSC (banking) - IPA (insurance)	FMA - integrated regulator
Licensing authority	CBSM, with final non-objection from Congress of State	Subject to French banking law and supervision - Final authorization granted by Minister of State	JFSC	FSC (banking) - IPA (insurance)	FMA
Independence	Partial (no separate budget, government controls licensing)	Subject to French banking law and supervision	Considerable independence with clear statement in law. MOU between JFSC and Ministry.	Very considerable independence - Dismissal of commissioners and budget issues remain elements of dependence.	Fully independent
Safety Nets/Contingency Planning					
LOLR	none	BDF	none	none	Swiis National Bank
Deposit Insurance	none	France	Pending	Yes (unusually extensive)	Swiss
Crisis Resolution	Framework in preparation	France	Framework in preparation	Framework in preparation	Framework in preparation
Cross-border Cooperation - Info Sharing Agreements	pending with Italy, Croatia	MOUs with France, Italy, Luxembourg, Belgium, UK, Swiss.	Tax information exchange agreements have been signed with the US, the Netherlands, Germany, Denmark, Finland, Greenland, Iceland, Sweden, Norway, the UK, France, Ireland, Australia, and New Zealand.	...	Committed in 2009 to OECD tax standards - signed 9 agreements to date.
Banking Secrecy	Strict - optional withholding tax regime offered to clients	Strict - any information sharing need formal MOU.	Relatively loose, a number of bilateral MOUs signed.	Relatively loose - exceptions include circumstances where disclosure is required to assist criminal proceedings or to enable the FSC to discharge its statutory functions.	Loosening - Will shortly adopt OECD standards on cross-border tax negotiations and offer bilateral tax deals on co-operation.
OECD list	Moneyval has lifted the enhanced compliance procedure last September 2009, and a new evaluation is planned for 2010. Currently on OECD White list.	MONEYVAL latest evaluation indicates satisfactory AML/CFT framework, with a range of issues requiring further action by authorities. Currently on OECD White list	Currently on OECD White list	Currently on OECD White list	Currently on "Grey" OECD list

Source: CBSM, respective countries' FSAP reports
1. As of end-2007
2. As of end-2008
3. As of end-2006

Appendix Table 8. San Marino: Summary Table of Stress Test Results

	Number of banks with with CAR below			Percent of assets in banks with CAR below 1/			Percent of assets in banks with no foreign parent with CAR below			CAR of banking system	% change in gross income of bank system	% change *in domestic* income of bank system	Banks forced to liquidate loans
	11 pct.	7 pct.	zero	11 pct.	7 pct.	zero	11 pct.	7 pct.	zero				
Current state of the banking sector													
	3	2	0	44.8	38.2	0.0	44.8	38.2	0.0	11.0			
Deterioration of Credit Quality and Reduction in Net Interest Income													
Loss of all good loans + 3x NPLs													
6 percent	8	6	3	89.1	51.1	11.7	69.9	51.1	11.7	4.8			
7 percent	8	6	4	89.1	51.1	46.5	69.9	51.1	46.5	3.6			
Loss of largest loan for each bank													
23 percent	5	4	3	65.3	46.5	39.9	65.3	46.5	39.9	5.7			
42 percent	7	5	5	69.9	65.3	65.3	69.9	65.3	65.3	0.8			
Reduction in net interest income													
56 percent	6	3	0	68.2	44.8	0.0	49.1	44.8	0.0	9.1	-25.4	-26.9	
Outflows of liquid liabilities													
Discount of 5 percent on bank loans, 5 percent on securities, 25 percent on customer loans													
17 percent	4	3	0	46.5	44.8	0.0	46.5	44.8	0.0	9.9	-4.1	-4.2	1
29 percent	5	4	1	65.6	46.5	34.8	46.5	46.5	34.8	7.3	-11.3	-11.6	3
55 percent	8	5	4	89.1	48.5	46.5	69.9	48.5	46.5	-0.6	-28.7	-29.5	7
Discount of 5 percent on bank loans, 10 percent on securities, and 25 percent on customer loans													
17 percent	4	3	0	46.5	44.8	0.0	46.5	44.8	0.0	9.3	-4.4	-4.6	1
27 percent	5	4	1	65.6	46.5	34.8	46.5	46.5	34.8	6.6	-10.8	-11.2	3
49 percent	8	6	4	89.1	68.2	46.5	69.9	49.1	46.5	-0.8	-25.9	-27.2	7
Discount of 5 percent on bank loans, 10 percent on securities, and 75 percent on customer loans													
15 percent	4	2	1	46.5	38.2	34.8	46.5	38.2	34.8	7.8	-4.5	-3.3	1

Sources: CBSM and IMF staff estimates.

1/ Assets measured before the stress occurs.

Box 2. Variation on the Liquidity Stress Tests

This complementary liquidity analysis examines an alternate scenario of deposit outflows in which different types of deposits have various outflow rates. It assumes that CRSM deposits are the least stable and have the highest outflow rate, followed by foreign (non-CRSM) deposits and then domestic (non-CRSM) deposits.

Banks are assumed to meet liquidity needs as follows: first with cash in vault and funds due from banks on demand, then with securities used for trading operations, followed by possibly less-liquid securities set aside to be held until maturity. Once these assets have been exhausted, banks would be forced to begin liquidating their loan portfolios.

The cumulative net cash balance refers to all the banking system assets that can be used to meet deposit outflows, i.e. everything other than customer loans. The point at which this balance becomes negative is the threshold at which banks are forced to liquidate loans.

The tests suggest that the system on aggregate is resilient to moderate outflows even under the assumption that the CRSM's Delta-related securities are not liquid.1/ However, a bank-by-bank analysis (not shown) indicates that illiquid banks would need to borrow from liquid banks in some scenarios.

Box Table 1. Summary Stress Test Results

Scenarios assuming Delta assets are recoverable at 75 percent

	Daily Deposit Outflow Rate (percent of total deposits)			Cumulative Net Cash Balance after 30 business days (In euro millions)		
	Domestic	Foreign	CRSM	**TOTAL**	**Domestic**	**Foreign**
Scenario 1a	0.25	0.5	1	2,733	1,096	1,638
Scenario 2a	0.5	0.75	1.25	2,046	697	1,348
Scenario 3a	0.75	1	1.5	1,358	299	1,059
Scenario 4a	1	1.25	1.75	670	-99	769
Scenario 5a	1.25	1.5	2	-18	-497	479

Scenarios assuming Delta assets are immobilized

	Daily Deposit Outflow Rate (percent of total deposits)			Cumulative Net Cash Balance after 30 business days (In euro millions)		
				TOTAL	**Domestic**	**Foreign**
Scenario 1b	0.25	0.5	1	1,743	105	1,638
Scenario 2b	0.5	0.75	1.25	1,055	-293	1,348
Scenario 3b	0.75	1	1.5	367	-691	1,059
Scenario 4b	1	1.25	1.75	-321	-1,090	769
Scenario 5b	1.25	1.5	2	-1,009	-1,488	479

1/ Preliminary data obtained from the CBSM after the FSAP mission indicate that about € 2.3 billion of outflows had occurred as of December 15, 2009 with an additional € 220 million still to be repatriated before end-June 2010. The overall financial system has been resilient so far, in part due to the introduction of reserve requirements by the CBSM. The stress tests suggest that the banking system could withstand an additional 20 to 25 percent of the outflows that had been recorded to that point.