



REPUBLIC OF THE MARSHALL ISLANDS

SELECTED ISSUES

September 2018

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August 10, 2018

Approved By
**Asia and Pacific
Department**

Prepared by Leni Hunter (APD) and Nadine Schwarz,
Jonathan Pampolina (both LEG)

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CORRESPONDENT BANKING RELATIONSHIP PRESSURES¹

A. Background

1. Correspondent banking relationships (CBRs) are important to RMI's economy. RMI uses the U.S. dollar as legal tender and currently does not have a monetary authority. The country has a high dependence on external aid from the United States. With the 2003 Compact of Free Association Agreement between RMI and the United States (the 2003 Compact Agreement), the U.S. has committed to providing annual grants averaging US\$36 million over 2004-23 (approximately 20% of annual GDP).² For these aid flows to reach their financial recipients, CBRs and local banks are needed. Similarly, Marshallese citizens who work for the U.S. military and U.S.-based companies in the Kwajalein Atoll rely on their local bank accounts to receive salaries from their U.S. employers through a U.S.-based bank. Remittance flows are primarily coursed through the two money transfer operators (Western Union and Moneygram), which also rely to some extent on the CBRs of the banks in the RMI.

2. RMI's two banks currently have access to the U.S. financial system. The Bank of the Marshall Islands (BOMI) is a domestic financial institution providing banking services to a substantial portion of the population and operates five branches throughout RMI, including on the Kwajalein Atoll. The First Hawaiian Bank (FHB), a subsidiary of BNP Paribas, is the BOMI's only remaining U.S. CBR. That said, in 2014, FHB issued a notice of CBR termination, which is to become effective once BOMI secured alternative arrangements (see discussion later). BOMI previously had two additional U.S. dollar CBRs, which were terminated in 2007.³ The other bank operating in the RMI, the Bank of Guam (BoG), is a foreign-owned bank with one branch in the main island of Majuro. It has its own American Bankers Association routing numbers to facilitate wire transfers from international locations and its deposits are insured by the U.S. Federal Deposit Insurance Corporation.

3. RMI, through the Trust Company of the Marshall Islands (TCMI), provides offshore corporate and maritime registry services. Under a 1990 joint venture agreement, TCMI administers the maritime and corporate registries in the RMI. Under the current legal framework, non-resident entities (i.e., not doing business in the country) can be established and registered in RMI (e.g., non-resident domestic corporations, limited liability companies, general partnerships, and domestic limited partnerships). It was previously reported that in 2010 as many as 30,000 non-resident entities were registered with TCMI, and since then, there has been a significant increase in the number of non-resident registrations.⁴ With respect to the maritime registry, more than 4,405

¹ Prepared by Jonathan Pampolina.

² IMF, 2016 Article IV Consultation (CR/16/260).

³ Chase Manhattan and Citizen's Security Bank (acquired by ANZ).

⁴ APG, [Mutual Evaluation Report](#): Republic of the Marshall Islands (2011).

maritime vessels (161 million in gross tons) are registered with TCMI as of June 2018. With twenty-seven offices worldwide, the RMI registries offer advantages including tax exemptions to non-resident companies on all incomes, port State control records with the U.S. and other major port countries (which facilitate faster processing of shipments), and the expertise of its personnel on maritime vessels and other matters. TCMI promotes a “one-stop shop solution” for maritime vessels and its offshore registry primarily caters to the company formation requirements of those entities in its shipping registry (e.g., asset management, yacht/vessel ownership, manning services). TCMI provides a portion of its earnings to the RMI government, pursuant to periodic agreements with the authorities, and submits its financial statements to the government, which are not publicly available. Under the 2017 appropriations act, a total of \$7.5 million (3.3% of GDP) from the ship registry was expected to be provided to the government budget in Fiscal Year 2018.

B. Trends and Drivers of CBR Pressures

4. BOMI, RMI’s only domestic bank, faces risks of an imminent termination of its CBR with FHB. In June 2014, BNP Paribas (FHB’s parent company) was sanctioned by U.S. regulators with a record US\$8.9 billion fine for violations of the sanctions list of the Office of the Foreign Assets Control. As part of the settlement, BNP Paribas agreed to a twenty-four month prohibition on its U.S. dollar clearing services as a correspondent bank, an agreement which also covered services provided by its subsidiaries including FHB.⁵ BNP Paribas thereafter directed FHB to sever all of its CBR ties with foreign banks, including BOMI. In October 2014, FHB notified BOMI of its intention to terminate its CBR by end-2014. Following interventions by U.S. agencies due to RMI’s strategic importance and the commitments under the 2003 Compact Agreement, BNP Paribas granted a special temporary exemption for FHB to maintain the current CBR with BOMI until the latter has secured alternative CBR arrangements. BOMI was required to submit to FHB and BNP Paribas quarterly reports on its progress. BNP Paribas and FHB nevertheless reserved the right to terminate the CBR should they find that the transactions in BOMI’s CBR account are inconsistent with the intended use or violated U.S. regulations.

5. Weak implementation of the anti-money laundering and combating the financing of terrorism (AML/CFT) framework by the authorities contributes to CBR pressures in RMI. In 2011, the Asia Pacific Group on Money Laundering (APG) highlighted shortcomings in the RMI’s AML/CFT framework and in its implementation, including with respect to the AML/CFT supervisory framework. These included inadequate information to carry out regular offsite compliance monitoring, as well as the lack of onsite examinations.⁶ The Banking Commission (RMI’s financial and AML/CFT supervisor for banks) pointed to the banks’ unsatisfactory submission of reports as contributing factors to poor compliance monitoring and supervision. Human resource constraints, including insufficient training, have also contributed to the ineffective AML/CFT supervision by the Banking Commission. Some officials of the private banks noted that onsite examinations were not regularly performed by the Banking Commission (e.g., banks said that the previous inspections were

⁵ New York State Department of Financial Services, [Consent Order: BNP Paribas, S.A.](#) dated June 29, 2014.

⁶ APG, [Mutual Evaluation Report](#): Republic of the Marshall Islands (2011).

more than several years ago). The weak AML/CFT regulatory environment adds to perceived risks accompanying CBRs with RMI banks.

6. Another source of risks to RMI's reputation are the vulnerabilities in the offshore corporate and maritime registries related to tax transparency and ownership information. The 2011 APG report found that the registry of non-resident companies does not contain accurate and current information on beneficial and legal ownership since there is no mandatory requirement to provide such information during registration nor is there an ongoing requirement to inform TCMI of any ownership changes. Non-resident companies are also permitted to issue bearer shares, even if resident domestic corporations are prohibited from doing so. The APG thus encouraged the RMI authorities to make disclosure of beneficial ownership a mandatory requirement for non-resident corporations and to implement measures to prevent the misuse of bearer shares. At present, the shortcomings continue to be a challenge, since RMI was recently included in the European Union's (EU) list of non-cooperative jurisdictions in taxation matters.⁷ Although the country was removed from the EU list in March 2018 after the authorities made high level commitments, there are still public concerns about the degree of entity transparency. For example, the Tax Justice Network, a non-profit organization, identified RMI as one of the top secrecy jurisdictions based on the scale of their offshore financial activities and gave the country poor ratings with respect to the legal entity transparency criteria.⁸ TCMI claims to timely respond to RMI authorities' requests for information by providing ownership information on non-resident companies based on their records.⁹ However, the quality and accuracy of the ownership information provided may be limited due to the absence of mandatory requirements for availability of ownership information in line with international standards. The presence of the offshore corporate and maritime registries contributes to the country's overall reputation risk, even if these registries and registered non-resident companies have little to no relationship or transactions with the banks operating in the country.¹⁰

C. Impact of CBR Pressures

7. The termination of BOMI's CBR with FHB would be expected to have significant negative economic repercussions without alternative arrangements. If BOMI was unable to secure alternative CBR arrangements and FHB decided to sever its CBR, BOMI's ability to serve its clients' needs would be substantially diminished owing to the lack of access to U.S. dollar clearing services. Disruptions to payment flows related to the grants under the 2003 Compact Agreement and other external aid would be expected. Marshallese citizens working for the U.S. military and U.S.-based companies would be particularly hard hit by such disruption since their salaries are ordinarily encashed or deposited with the BOMI branch in Kwajalein Atoll. Owing to policy

⁷ Council of the European Union, [EU List of Non-Cooperative Jurisdictions for Tax Purposes](#) (December 5, 2017). The country was also previously included in the Organization for Economic Co-operation and Development's (OECD) list of uncooperative tax havens, but exited the list in 2007.

⁸ Tax Justice Network, [2018 Financial Secrecy Index](#).

⁹ Most foreign requests for information received by the Domestic Financial Intelligence Unit involve information pertaining to ownership of non-resident companies registered with TCMI.

¹⁰ In fact, BOMI has a policy in place that prohibits it from dealing with non-resident companies.

restrictions, the U.S.-based bank providing services to the American military and other American personnel in Kwajalein Atoll are not permitted to bank Marshallese citizens.

8. BoG’s continuing access to the U.S. financial system could mitigate the impact of the termination of BOMI’s CBR, but would not resolve all challenges and risks. The BoG provides an alternative to Marshallese citizens who require banking services for cross-border payments or transactions. Since the BoG is monitored and regulated by several U.S. agencies, its direct access to the U.S. financial system is less at risk as compared to a respondent bank that relies on its CBRs with a foreign correspondent bank. Nevertheless, the concentration of U.S. dollar cross-border payments or transactions into BoG presents challenges unrelated to the domestic context, owing to the bank’s foreign-ownership (e.g., potential effects of business decisions of bank headquarters). Its lack of presence or branches in other islands (e.g., Kwajalein Atoll) may limit the scope of banking services that BoG can offer to the country, which could prove problematic for Marshallese citizens needing to encash or deposit their salaries from the U.S. military or U.S.-based companies. While the BoG has established AML/CFT controls and uses electronic systems for detecting and filing suspicious transaction reports, the impact to RMI’s dollarized economy of any future major scandal or violation of U.S. regulations involving BoG could be heightened since the bank will be the sole remaining access point to the U.S. financial system. The potential issuance of the decentralized digital currency could increase the ML/TF risk profile of the country, and impact the decision and risk assessment of BoG’s headquarters.¹¹

9. The general impact of CBR pressures on overall remittance flows do not appear to be significant at present. BOMI provides Moneygram services for sending and receiving cash without the need of a bank account. Western Union provides money transfer services through its two branches in Majuro and Kwajalein Atoll. Western Union applies company-wide AML/CFT controls including customer due diligence measures (identification of sender and recipient, source of funds, senior management approval for transactions above a threshold), automated record-keeping system and independent reviews of their systems. Owing to limited information, the RMI authorities were not able to provide insights on the potential impact of CBR pressures to remittance flows. However, the Banking Commission is developing CBR forms for banks and money transfer operators to receive data on volumes and values of funds sent and received on a monthly basis. Money transfer operators nevertheless have not noticed any significant change in the volume or value of the remittances in the past few months. The costs of remittances for both money transfer operators seem to remain steady without any significant price fluctuations. Except for those Marshallese citizens receiving salaries from U.S. military or U.S.-based companies in the Kwajalein Atoll, the projected impact of the termination of BOMI’s CBR to the country’s overall remittances remains unclear at present, especially since money transfer operators offer an alternative remittance channel.

D. Actions to Address CBR Pressures

10. BOMI officials are seeking to secure alternative arrangements and address CBR pressures. They are consulting with legal experts to establish a clearing house facility in Hawaii that

¹¹ See also Selected Issues Paper “The SOV–RMI’s decentralized digital currency.”

would enable the bank to have direct access to the U.S. financial system for check-clearing and wire transfer services. Given the required approvals from several U.S. authorities (e.g., U.S. Federal Reserve) and the need for compliance with U.S. banking and AML/CFT regulations, the processing of BOMI's application is expected to be lengthy and protracted. BOMI had approached other U.S. banks to start new CBRs, but these efforts have so far not been successful, owing to these banks' concerns about risk management in RMI, costs and profits. With technical support from FHB, BOMI continues to strengthen its AML/CFT compliance program and has instituted additional controls including upgrading its AML/CFT software for detecting suspicious transactions, an independent audit of its AML/CFT system, designation of compliance officers, and training of BOMI staff.

11. The RMI authorities are strengthening the effectiveness of the AML/CFT framework. As regards AML/CFT supervision, RMI authorities, with assistance from the Financial Services Volunteer Corps (a U.S.-based non-profit organization), have amended the Banking Act to strengthen the legal framework for AML/CFT supervision (e.g., ensuring supervisory coverage of other financial institutions and designated non-financial businesses and professions). They are also developing manuals and procedures to enhance the effectiveness of AML/CFT supervision. The Banking Commission is conducting on-site AML/CFT examinations of banks and provides support to BOMI with respect to the latter's quarterly reporting to FHB and BNP Paribas (e.g., updates on strengthening the AML/CFT supervisory framework and implementation). In this respect, supervisory personnel have been added by the Banking Commission. The establishment of a Monetary Authority is also being explored to alleviate CBR pressures. The RMI authorities recognized however that the proposed agency may have limited impact on alleviating CBR pressures since its possible monetary account abroad (e.g., Federal Reserve Bank of New York) may not be able to serve the CBR needs of BOMI owing to potential legal and operational constraints and risk exposure to the agency. With respect to offshore corporate and maritime registries, amendments to the Associations Law now require corporations issuing bearer shares to use all reasonable efforts to obtain and maintain information on the beneficial owners of the bearer shares, and to cancel all bearer shares that do not comply with recordkeeping obligations within the prescribed 360-day phase-in period. Finally, the RMI authorities have engaged the World Bank to assist in the conduct of the RMI's first assessment of its money laundering and terrorist financing risks, which involves the relevant public agencies (e.g., the Banking Commission, the financial intelligence unit, police commissioner, attorney-general, etc.) and private stakeholders.

12. Additional steps should be taken to further lower the risk of losing the last U.S. dollar CBR. Once the national risk assessment is completed, an action plan should be developed to address the identified risks. The authorities' capacity to conduct risk-based AML/CFT supervision should continue to be upgraded, building on technical assistance from international organizations. Since the offshore corporate and maritime sectors still present ML/TF risks, staff also recommends imposing AML/CFT obligations on both relevant registries, as well as ensuring that requirements aimed at increasing transparency of beneficial ownership of legal persons are duly implemented (including with respect to existing legal persons and bearer shares issued prior to November 2017) and that competent authorities have timely access to up-to-date beneficial ownership information of non-resident companies.

THE SOV—RMI'S DECENTRALIZED DIGITAL CURRENCY¹

The Republic of the Marshall Islands (RMI) passed legislation to enable the issuance of a second legal tender in the form of a “decentralized digital currency based on blockchain technology”, to be called the Sovereign, or SOV. A private sector third party designated by the RMI authorities is developing the software intended to support the SOV. At the time of drafting a number of questions on the practicalities and implications of the law remained unanswered. In staff’s view, in the absence of clear mitigating measures, the macroeconomic and financial integrity risks associated with the SOV exceed the potential benefits. Staff has therefore recommended that the authorities seriously reconsider issuance of the SOV.

A. Introduction

1. In February 2018, the RMI Parliament passed the “Declaration and Issuance of the Sovereign Currency Act 2018” (the “SOV Act” or the law). The intended purpose of the SOV Act is to lay the legal foundation for the issuance of a “digital decentralized currency,” dubbed the Sovereign, or SOV. The SOV is to be based on blockchain technology, and the law declares it as legal tender in the RMI, in addition to the United States (U.S.) dollar. Pursuant to the law, the SOV will be issued by the Ministry of Finance and will be non-redeemable. It will be introduced via an initial coin offering (ICO), which the appointed organizer – a foreign start-up with limited financial sector experience – has been tasked to perform. The law also requires transparency over the identity of the users of the SOV (more specifically the encryption of identification information on the blockchain) but the scope and practicalities of the requirements remain to be established.

2. The main purpose of the SOV’s introduction is to generate revenue gains for the government. The RMI is a small island country that faces risks from natural disasters and climate change, and is heavily reliant on external aid, mainly from the U.S. The RMI does not have a central bank to set monetary policy. The ability to generate revenue gains would be new, and derives from the country’s ability to designate the SOV as legal tender for the purchase of goods and services within the RMI.² The authorities envisaged that revenue gains from the issuance of the SOV will assist with the anticipated reduction of U.S. Compact grants after 2023.³

¹ Prepared by Leni Hunter and Nadine Schwarz.

² The concept of legal tender can vary across jurisdictions. As noted in He and others, 2016, “Currencies are given the status of legal tender under the state’s legal framework, which generally entitles the debtor to discharge monetary obligations with the currency through its mandatory acceptance within the relevant jurisdiction.”

³ RMI entered its “Compact of Free Association” with the US in 1986. The first financial package of the Compact lasted from 1986 to 2003, and in 2003 the Compact was renewed for a further 20 years. A Compact Trust Fund (CTF) was created to contribute to the long-term budgetary self-reliance of RMI after the expiry of Compact’s financial provisions in 2023.

3. The issuance of the SOV would put the RMI into largely uncharted territory for financial regulation and monetary policy. The SOV Act was passed at a time when there is little certainty regarding the best regulatory approach to virtual currencies/crypto assets.⁴ Regulatory challenges are heightened due to virtual currencies/crypto assets' novelty and the speed with which they are evolving, as well as the current lack of global consensus on the appropriate regulatory approach. At the same time, the SOV puts the RMI at the frontier of crypto assets as legal tender. While perhaps less immediate than financial integrity risks, the monetary issues are likely to prove no less challenging in the medium term.

4. The authorities have noted that the SOV would only be issued once the planned issuance and use of the SOV are deemed to comply with the FATF standard and U.S. regulations. The authorities also noted that the SOV would only be issued once its use in transactions in the U.S. financial system has been approved by the U.S. government (as in the case of other countries' fiat currencies). The authorities added that they would shift their focus to addressing challenges to macroeconomic management at later stage. Considering all of these preparations, they expected it would take few years to issue the SOV.

5. This Selected Issues Paper provides further background on the SOV, and discusses the potential benefits and main risks that the SOV issuance raises for the RMI. The purpose of this Paper is not to be exhaustive, considering that not all issues have been considered and addressed by the government. Rather, this Paper aims to provide a discussion of the most immediate challenges or concerns, in particular the potential financial integrity risks and challenges to macroeconomic management.

B. Some Background on Privately Issued Virtual Currencies/Crypto Assets

6. Virtual currencies/ crypto assets can present important benefits.⁵ They can enable fast and inexpensive financial transactions, while offering some of the convenience of cash. Moreover, the underlying technology of crypto-assets—distributed ledger technology, or DLT—could help financial markets function more efficiently, or aid the secure storage of important records such as medical records or land sales.

7. Virtual currencies/crypto assets also raise new risks,⁶ notably risks of being misused for money laundering (ML), terrorist financing (TF) and other illegal activities.⁷ This is in part due to their

⁴ This paper refers to “virtual currencies/crypto assets” in keeping with the terminology used by the Financial Action Task Force in its most recent report to the G20 Ministers of Finance and Central Bank Governors <http://www.fatf-gafi.org/publications/fatfgeneral/documents/report-g20-fm-cbg-july-2018.html>

⁵ See IMF Blog Christine Lagarde, April 2018, “An Even-Handed Approach to Crypto-Assets”.

⁶ See, amongst others, the March 18, 2018 Communique of the G20 Finance Ministers and Central Bank Governors, which notably indicates that “Crypto-assets do, however, raise issues with respect to consumer and investor protection, market integrity, tax evasion, money laundering and terrorist financing.”

⁷ Examples of ML include the Liberty Reserve case – the Liberty Reserve was an online payment system that issued its own virtual currency and knowingly facilitated ML activities among criminals. In other examples, the Bitcoin and other

varying degrees of anonymity or “pseudo-anonymity,” decentralized nature, global reach, speed of transaction, and segmentation of services. These features enable users to execute both domestic and cross-border transactions swiftly, in relative secrecy, and, in many cases, without the presence of a regulated intermediary. They facilitate easy online access and global reach which make them attractive to move and store funds not only for legitimate purposes, but also for ML/TF purposes.⁸ Without effective implementation of appropriate AML/CFT measures, they therefore pose a threat to the integrity of financial systems (domestic and international). The range and level of risks vary greatly depending on the intrinsic characteristics of the virtual currency/crypto asset in question, the type of operating model, and the context (in the country of issuance and the country of use).

8. There is currently no common approach to the AML/CFT regulation and risk mitigation of virtual currencies/crypto assets: countries have taken different approaches (see below). The Financial Action Task Force (FATF, the standard setter for AML/CFT)⁹ has been following the developments for some time. It has notably issued guidance¹⁰ in 2015 on the risk-based approach to virtual currencies,¹¹ which focuses on the points of intersection that provide gateways to the regulated financial system, in particular convertible virtual currency exchangers. The FATF has several ongoing areas of work designed to encourage appropriate and consistent safeguards that will contribute to the mitigation of the ML/TF risks associated with virtual currencies/crypto assets while avoiding unnecessary barriers to legitimate use.¹²

C. The SOV

9. The SOV is intended to be a “digital decentralized currency” based on blockchain technology.¹³ The concept of “digital decentralized currency” is not defined in the law but is generally understood to capture what the Fund and others have also referred to as crypto assets, i.e., “digital

virtual currencies have been used to purchase illegal goods (such as in the Silk Road case), or used in “ransomware” attacks.

⁸ See FATF’s June 2018 report to the G20.

⁹ The FATF’s “International standards on combating money laundering and the financing of terrorism and proliferation: the FATF Recommendations” have been endorsed by the Fund as the relevant AML/CFT standard for the purposes of its work.

¹⁰ FATF, 2015, Guidance for a Risk-Based Approach to Virtual Currencies [http://www.fatf-gafi.org/documents/riskbasedapproach/documents/guidance-rba-virtual-currencies.html?hf=10&b=0&s=desc\(fatf_releasedate\)](http://www.fatf-gafi.org/documents/riskbasedapproach/documents/guidance-rba-virtual-currencies.html?hf=10&b=0&s=desc(fatf_releasedate))

¹¹ The FATF June 2014 report on “Virtual Currencies – Key Definitions and Potential AML/CFT Risks” defines a “virtual currency” as “a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. “real currency,” “real money,” or “national currency”), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. E-money is a digital transfer mechanism for fiat currency- i.e., it electronically transfers value that has legal tender status.”

¹² See July 2018 FATF Report to G20 Ministers of Finance and Central Bank Governors mentioned above.

¹³ The SOV Act does not define “digital decentralized currency” but defines “blockchain” as “an open, distributed ledger that can record transactions between two parties efficiently and in a verifiable and permanent manner.”

representations of value, made possible by advances in cryptography and distributed ledger technology¹⁴, or more broadly as “virtual currencies/crypto assets.” The intention is for the SOV, to be denominated in its own units of account and to be transferred peer-to-peer, without intermediary.

10. The SOV is also intended to be the RMI’s second legal tender, thereby raising problems of macroeconomic management under a dual currency system. The law declares the SOV as legal tender of the RMI for all debts, public charges, taxes and dues. It also amends the General Fiscal Matters Act (which identifies the U.S. dollar as the RMI’s legal tender) with the addition of a reference to the SOV as legal tender of the RMI alongside the U.S. dollar. It is worth noting that, in the case of the RMI, the designation of the U.S. dollar as the country’s legal tender is also set in an international agreement, more specifically in the Compact of Free Association. Section 251 of Compact provides that, should the government of the RMI act to institute another currency, the terms of an appropriate currency transitional period shall be as agreed with the U.S. Government. At the time of drafting, the U.S. Government had not formally taken a position on the legal implications of the SOV Act under the Compact.

11. The SOV is not equivalent to a central bank digital currency (CBDC). As noted by the Bank for International Settlements (BIS), CBDCs are not well defined but are “*envisioned by most to be a new form of central bank money. That is, a central bank liability, denominated in an existing unit of account, which serves both as a medium of exchange and a store of value.*”¹⁵ Although the SOV is intended to be a form of digital currency, it will not be a CBDC because (1) it may not fulfill the functions of money (see below), (2) it will not be a central bank liability, and (3) a CBDC should be convertible at par with the cash and reserves used in the country, whereas there is no policy to ensure that the SOV is convertible at par for USD by the RMI authorities.

12. The number of SOV units at issuance will be fixed at 24 million units, to be distributed equally between the RMI and the appointed organizer. The SOV is to be issued by the Ministry of Finance and introduced via an initial coin offering (ICO),¹⁶ which will be performed by the appointed organizer. Prior to the ICO, the RMI will maintain 12 million SOV units, and 12 million SOV units will be for benefit of the appointed organizer. The appointed organizer will bear the costs necessary to issue the SOV and perform the ICO. During the ICO, the RMI will sell 6 million of their 12 million units. RMI’s ICO proceeds (sale of 6 million SOV units) and RMI’s remaining SOV units (6 million SOV units), will be allocated to various RMI trust funds (Figure 1). Each SOV unit will be divided by 100 sub-units.

¹⁴ He, 2018.

¹⁵ BIS, 2018, “Central Bank Digital Currencies”.

¹⁶ The SOV Act defines the ICO as “the process of issuing a new digital decentralized currency and offering to users worldwide.”

Figure 1. Initial Issuance of 24 Million SOV, and Distribution of RMI's 12 Million SOV

Appointed organizer: 12m SOV (Appointed organizer will bear all costs necessary to issue the SOV issuance and perform the ICO)	RMI: 6m SOV sold in ICO		RMI: remaining 6m SOV 1/	
	RMI National Trust Fund 3m	RMI Nuclear Legacy Fund, Healthcare Fund 2.4m GCF 0.6m 2/	RMI National Trust Fund 3m	RMI Resident-Citizen SOV Allocation Fund 2.4m GCF 0.6m

1/ Distributed evenly over 5 years. 2/ GCF is the RMI Green Climate Fund.

13. According to the law, the supply of SOV units will grow at 4 percent a year relative to the amount of SOV units in existence during the past year. The new SOV units may, by decision of the Ministry of Finance and the appointed organizer, be distributed either pro-rata to all SOV owners on RMI Constitution Day at noon every year, or as mining fees to miners¹⁷ on the SOV blockchain. Discussions with the authorities and representatives from the appointed organizer indicated that the details of the mining process are still to be finalized.

14. Following the ICO, RMI residents are supposed to be provided with the necessary means to hold, save, and conduct transactions with SOV. Pursuant to the SOV Act, merchants in the RMI are supposed to be provided with access to a mobile and/or personal computer application with which they will be able to receive payments made with the SOV.

15. An Oversight Committee has been established to monitor the issuance and trading in SOV. Pursuant to the SOV Act, the AML provisions of the Banking Act (Part XIII) will apply to the ICO process and to any trading, conversion and transfer of SOV in the RMI. The Minister of Finance may, in addition and in order to ensure the safety and soundness of the licensed banks in the RMI, promulgate necessary regulations to ensure effective monitoring of the ICO process and trading in the SOV. During its March 5, 2018 meeting, the RMI Cabinet approved the establishment of Oversight Committee comprised of the Chief Secretary (Chairperson), Secretary of Finance, Banking and Postal Services (Vice Chairperson), Attorney General or designee, Banking Commission (or designee) and a private sector representative to be determined by the above-mentioned members. The Committee’s mandate is to maintain overall oversight of the issuance and trading of the SOV; monitor the “pre-initial ICO and the ICO processes by maintaining contact with the appointed organizer, and accessing information contained on the blockchain; act as the conduit between the appointed organizer and the RMI Government; approve currency exchanges where the SOV will be traded; reporting suspicious transactions detected at the issuance and during the trading in SOV; and approve the appointment of attorneys, “KYC firms,” and the audit firms, and other experts to assist the RMI in areas of need in connection with the SOV.

¹⁷ The SOV Act defines “miners” (rather than “mining”) as “a validation of transaction in a blockchain-based digital currency network; successful miners obtain new currency as a reward.”

16. One of the key features of the SOV is its planned transparency – more specifically, the encryption on the blockchain of the users’ identity. Pursuant to the law, “all users of the SOV will be required to undergo standard know-your-customer (KYC) procedures and requirements as may be promulgated by the Banking Commissioner, and their identities encrypted on the blockchain.” The purpose is to ensure greater transparency over transactions in SOV than in other virtual currencies/crypto assets, thus limiting the incentive for criminal misuse.

17. The underlying technology for the SOV is currently being developed by the appointed organizer. Work on the SOV protocol (i.e. the rules based on the blockchain technology that will support the SOV) is ongoing. It is reported that the intention is to develop a hybrid blockchain based on a permissioned protocol which requires users to authenticate a non-anonymous blockchain system that can operate within a regulated environment. Discussions with representatives of the appointed organizer highlighted that the protocol is still in the relatively early stages of development. The organizers are notably seeking financial support from potential investors to develop the technical design of the SOV. They are also seeking to identify key features of the SOV beyond the use of distributed ledger technology, including the interface with the traditional financial system. More specifically, they are seeking to strike the appropriate balance between protecting the users’ privacy and abolishing secrecy. To this end, the appointed organizer is seeking the advice of a reputable law firm on the type of information that is required by the U.S. AML/CFT framework.

D. Some Considerations About the Potential Benefits of the SOV

18. SOV issuance may enable the RMI to generate revenue gains, to assist with fiscal adjustment. The authorities intend that the SOV’s legal tender status will bolster confidence in and demand for the SOV, and that this would in turn increase the value of the SOV, and, ultimately, provide a sound source of revenue. This new source of revenue would help adjust to reduced Compact grants, and to finance expenditures including social expenditures and RMI’s response to climate change.

19. Depending on its final configuration, the SOV could theoretically include other benefits generally associated with virtual currencies/crypto assets. These could include greater speed and efficiency in making payments and transfers—particularly across borders (e.g. remittance flows).

E. Some Considerations About the Potential Risks and Challenges of the SOV

Financial Integrity risks

20. The SOV Act was adopted without prior assessment of the potential financial integrity risks associated with the SOV. Pursuant to the AML/CFT standard, countries should identify, assess and mitigate the ML and TF risks that they face. This includes assessing and mitigating the risks that may arise in relation to the development of new products and new business practices, including new

delivery mechanisms, and to the use of new or developing technologies for both new and pre-existing products.¹⁸ The planned issuance of the SOV is the RMI authorities' initiative – the authorities should, therefore, have given due consideration to the potential ML/TF risks and their mitigation prior to the adoption of the enabling law, in particular considering the important financial integrity concerns that virtual currencies/crypto assets have raised.

21. There is a general recognition of the need to mitigate the risks that virtual currencies/crypto assets pose to financial integrity, but there is currently no common AML/CFT regulatory approach to mitigate those risks. According to a recent survey conducted by the FATF, the range of regulatory responses is broad: (i) Some countries have prohibited the use of all virtual currencies/crypto assets, or have prohibited financial institutions from dealing in virtual currencies/crypto-assets; (ii) Several countries apply anti-money laundering / countering the financing of terrorism regulations to virtual currency/crypto-assets (and the associated exchanges), for example by using existing AML/CFT laws and regulations governing money and value transfer services, banks, or other payment institutions, based on clarifications that these regulations apply to virtual currency/crypto-asset exchangers; (iii) Some countries do not specifically regulate virtual currencies/crypto-assets or exchanges dealing in them, but have broad-based requirements to report suspicious transactions, including those transactions related to virtual currencies/crypto-assets, and some go beyond regulated entities (i.e., applying suspicious activity reporting requirements to virtual currency/crypto-asset exchangers); (iv) Many countries are in the process of establishing law or regulations.¹⁹

22. This entails that the use of the SOV is likely to be exposed to very different regulatory regimes. The absence of a common approach to AML/CFT regulation of virtual currencies/crypto assets is relevant to the RMI for two main reasons: first, it entails that there is no defined standard or best practices to guide the authorities in the mitigation of the potential AML/CFT risks of the SOV; second, it also entails that, regardless of the regulatory approach taken within the RMI, it will likely be challenging to ensure that appropriate AML/CFT measures are also applied to the trading of the SOV abroad. The authorities indicated that their intention is for the SOV to be traded on pre-approved exchange platforms only, and that they have tasked the Oversight Committee with the approval process. It is, however, unclear what the conditions for authorization will be, and how the RMI authorities will ensure that the foreign exchange platforms that they have approved for SOV trading are duly regulated and supervised for AML/CFT purposes. It is also unclear how they will address mining activities abroad.

23. It is premature to conclude that the planned transparency of the SOV will adequately mitigate the risks of criminal misuse. One of the features that make virtual currencies/crypto assets attractive to criminals is their anonymity, or "pseudo anonymity," i.e. the fact that in most cases, while it is possible to track transactions, it is generally more complicated (and at times close

¹⁸ See in particular FATF Recommendations 1 and 15.

¹⁹ FATF July 2018 Report to G20 Ministers of Finance and Central Bank Governors.

to impossible) to identify the persons behind those transactions.²⁰ The authorities' intention is precisely to overcome that obstacle: the requirement in the SOV Act to include, on the blockchain, the identity of all users is intended to render the SOV more transparent than other virtual currencies/crypto assets, and thus less attractive to those wishing to remain unknown and untraceable. At the time of drafting, however, no additional regulation or information was available on the extent and modalities of the anticipated customer due diligence measures ("standard KYC procedures") that would need to be taken to identify persons behind transactions. As a result, a number of key questions related to the planned transparency of the SOV remain unanswered. In particular,

- Who are the "users" of the SOV subject to identification?

The law refers to but does not define the "users" of the SOV. Based on discussions with the authorities and representatives of the appointed organizer, the notion of "user" appears to be generally understood to capture the persons behind the sender's private key but this remains to be confirmed. No consideration seems to have been given to beneficial owners of SOVs, and it is unclear whether miners will be included.

- Who is expected to perform the customer due diligence?

The SOV Act does not specify who should undertake customer due diligence. It provides that digital currency exchanges in the RMI will be regulated for AML/CFT purposes,²¹ which could suggest that, at least domestically, RMI exchanges will be the ones in charge of the customer due diligence process. In principle, this would be in line with the FATF guidance. However, discussions with the authorities also indicated that a single foreign private sector firm would be tasked with the identification of users. It is unclear if this will be the case of all potential purchasers of the SOV or only those approaching the RMI's domestic exchange platforms. More generally, as mentioned above, it is unclear how the authorities will ensure that the trading of SOVs abroad is subject to adequate AML/CFT measures, including effective supervision or monitoring, and that the SOV is not traded on unauthorized platforms. Finally, it is not clear how the customer due diligence requirements are expected to apply in the context of SOV mining, and who will encrypt the information on the blockchain (e.g., the third party "identifier" or digital currency exchangers or individual users).

- What will be the exact scope and modalities of the customer due diligence requirements?

The authorities and representatives of the appointed organizer mentioned that the SOV protocol will provide transparency regarding the name of the users *and* the source of their funds, but only the

²⁰ Virtual currencies/crypto assets are not uniformly anonymous – there are varying degrees of anonymity depending on the type of virtual currency/crypto asset and on the use of privacy enhancing services.

²¹ The SOV Act provides that "digital currency exchanges in the RMI shall be regulated by the responsible government entity to ensure that they are licensed and regulated consistent with anti-money laundering requirements under the Banking Act."

first element appears to be considered. Pursuant to the SOV Act, the AML provisions in the Banking Act will apply to the ICO process and to the trading, conversion or transfer of the SOV in the RMI. These provisions notably include customer due diligence requirements for financial institutions and cash dealers, as well as reporting and record keeping requirements that are only broadly in line with the FATF standard. Discussions with representatives of the appointed organizer indicated that the intention is to enable identification of the user on the basis of governmental ID documents, proof of residency and possibly a fingerprint biometric marker (which is not currently envisaged in the Banking Act). Once the information is encrypted, it is not clear whether and how changes in the identified person's risk profile will be taken into account.

- What level of transparency will the blockchain provide?

The SOV Act provides that the users' "identities will be encrypted on the blockchain." Discussions with the authorities and representatives of the appointed organizers indicated, however, that this is still under consideration (see also following paragraph below). According to some, the receiver of SOVs will be able to see information on the identity of the last two senders. According to others, broader information will be visible to all. Regardless of how much information is eventually on the blockchain, the intention seems to be that all identification information will be accessible to the authorities including law enforcement under certain conditions that are, however, still to be determined.

- Who will be responsible for the encryption of the information on the blockchain?

The assumption so far seems to be that the encryption will be incumbent upon the appointed organizer at the time of issuance, and possibly of the exchangers thereafter, but this remains to be confirmed. It is unclear whether any identification information will need to be encrypted during the mining process.

24. The answers to these questions, as well as the level of implementation of the transparency requirements will be key in establishing the extent to which the planned transparency will deter criminal misuse of the SOV. While the RMI authorities will be responsible for ensuring compliance with the requirements in the RMI, they will have limited controls over the implementation of these requirements abroad. In addition, transparency in itself may not be sufficient.

25. Little additional information is available. It is, for example, unclear how and by whom compliance with customer due diligence and reporting obligations will be monitored. The SOV Act indicates that the "Legal Tender Committee shall ensure [the] KYC process and requirements are effectively applied at the ICO process." The recently established Oversight Committee seems to have overtaken that role and has been given a broader mandate: it has been tasked with a general mandate of overseeing the issuance and trading of the SOV (i.e. its oversight is not limited to the ICO process) as well as to report suspicious transactions. The modalities of that oversight are still to be established, and it is not clear how they would apply outside exchange platforms (e.g., in the case

of mining). Finally, as mentioned above, it is anticipated that most of the SOV trading will take place abroad, which potentially exposes the SOV to significant regulatory arbitrage.

26. Transparency is only one element of an effective AML/CFT framework. In addition to a clear identification process, effective mitigation of the risk of criminal misuse of the SOV will require the backing of an effective AML/CFT framework. The effectiveness of the RMI's framework has not yet been assessed. The RMI's last AML/CFT assessment was conducted in late 2010, with the assessment report being adopted in July 2011.²² Overall, the RMI was found to have reasonably sound AML/CFT measures in place, but the assessment also noted that some technical and implementation deficiencies remained.²³ The next assessment is tentatively scheduled to take place in October 2020, and will notably establish the extent to which the RMI is effective in addressing its ML/TF risks. High effectiveness ratings require adequate proof that the AML/CFT framework is being applied and that it is achieving a series of eleven predetermined outcomes set in the assessment methodology. These outcomes cover a range of elements in addition to effective implementation of customer due diligence measures and reporting of suspicious transactions.²⁴ In the case of the SOV, the RMI should also be attuned to the risks, to its domestic financial system, that may result from the use and trading of the SOV abroad, and be able to establish that it is adequately mitigating those risks.

27. As a result of the risks associated with digital currencies/crypto assets and of the lack of clear mitigating measures for the SOV, the enactment of the law has increased pressure on the RMI's remaining U.S. CBR. While the CBR currently remains in place, it is not clear that this will still be the case once the SOV is issued (see relevant SIP).

Challenges to Macroeconomic Management

28. Even as legal tender, the SOV may not become money, as it may not fulfill all the functions of money.²⁵ The ability of SOV to function as a medium of exchange is unclear,

²² The assessment was conducted by the Asia/Pacific Group on Money Laundering, the FATF-style regional body of which the RMI is a member.

²³ The deficiencies identified pertained to elements of the ML and TF offenses; mechanisms for freezing TF funds without delay and domestic designation; controls on movement of cash across borders; supervision of non-bank financial institutions and cash dealers; and implementation of the FATF standards amongst the designated non-financial businesses and professions (DNFBPs), in particular company service providers. The assessors also found that the ML/TF risks in the RMI derived mainly from its offshore company registration sector.
<http://www.apgml.org/members-and-observers/members/member-documents.aspx?m=38e5eb19-a643-4bfd-bf13-15838814df87>

²⁴ Examples of additional outcomes of an effective AML/CFT system include: legal persons and arrangements are prevented from misuse for ML/TF, and information on their beneficial ownership is available to competent authorities without impediment; ML offenses and activities are investigated and offenders are prosecuted and subject to effective, proportionate and dissuasive sanctions.

²⁵ Money is commonly defined by way of its functions. These are: (1) medium of exchange, (2) store of value, (3) unit of account. A fourth function, standard of deferred payment, may also be added. See IMF, 2000, "Monetary and Financial Statistics Manual" pp 57,58. In addition, whether an asset is used as money depends on factors including general acceptability, stability of value, liquidity and acceptability, and long-term stability of supply. See Ariyoshi, 2017.

particularly as limited telecommunication infrastructure will likely be an obstacle to the SOV becoming a widely-used medium of exchange for some time. The SOV's use as a store of value will depend on its stability: elevated exchange rate volatility will make the SOV less attractive as a store of value. In addition, general acceptability of the SOV would require stability of a sufficient degree to ensure that trust in the SOV's value is preserved.²⁶ There does not appear to be an intention to price goods and services in SOV, or to use the SOV as a unit of account in RMI.²⁷

29. Regardless of whether it fulfills the functions of money, the SOV will affect monetary conditions and pose challenges to macroeconomic and liquidity management. As a crypto asset and an international currency, the SOV may be subject to large volatility in its exchange rates.²⁸ High volatility in the SOV exchange rate could pose significant monetary and financial stability risks to the RMI, particularly given SOV's status as legal tender.²⁹ For example, episodes of strong SOV appreciation (depreciation) would increase (lower) the wealth and purchasing power of SOV holders, affecting demand for goods and assets in RMI, with potentially large consequences for inflation and asset prices. Instability in the value of the SOV will likely be most relevant for residents, who can easily buy goods or other assets locally. However, expenditure of foreign-held SOV within RMI could independently pose additional risks to inflation and asset prices, depending on the convertibility of the SOV and the capital flow regime. At present there is no exchange rate policy, and no policy mechanism for the authorities to ensure convertibility of SOV to other currencies. If SOV is not easily convertible to other currencies/assets, then foreigners may be encouraged to spend SOV within the RMI, depending on how readily they can move SOV into and out of the RMI.

30. The SOV would introduce risks of currency mismatch, and liquidity risk. SOV volatility would affect the balance sheets of all RMI agents with SOV exposure, including the government, banks, households and firms. For example, if government received tax revenue in SOV, and the SOV subsequently depreciated, the USD value of the government's revenue collection would fall. Alternatively, if a bank received debt servicing payments in SOV, and SOV subsequently depreciated, the net value of the banks' assets would be reduced. Any agent that received SOV payments against USD denominated liabilities would face risks of currency mismatch: that is, currency movements that cause the value of revenue and assets to fall relative to the value of payments and liabilities. In addition, as the SOV can be used to settle debts and taxes, the government and the local bank could face U.S. dollar liquidity risks under currency convertibility. The currency mismatch and liquidity risks could be offset to the extent that agents can both receive and make payments in SOV. However, while for example, the law obliges the government to receive tax payments in SOV, there may be

²⁶ The value of fiat currencies is anchored by legal tender status and monetary policy, as noted in He, 2018.

²⁷ Staff's current understanding is that government taxes, fees and charges would continue to be denominated in U.S. dollars.

²⁸ See IMF, 2018, "Global Financial Stability Report: A Bumpy Road Ahead", Chapter 1. As noted by He, 2018, "the value of crypto assets rests solely on the expectation that others will also value and use them. Since valuation is largely based on beliefs that are not well anchored, price volatility has been high."

²⁹ Crypto-assets do not necessarily create significant financial stability risk: a small footprint has been one reason for assessments of low financial stability risks from crypto-assets in other contexts (Lagarde, 2018).

practical barriers to making government payments SOV (such as infrastructure limitations, as noted above).

31. Uncertainty about a monetary policy framework elevates the risks of monetary instability. The 4 percent annual growth rule of the SOV supply was stipulated in the SOV Act as it is expected to help stabilize the value of the SOV and achieve monetary stability. If implemented as allowed for in the SOV Act, the 4 percent growth rule would increase SOV supply, but without necessarily being appropriate for RMI's economic conditions at any point in time. However, the authorities noted that the appointed organizer will develop a separate stability mechanism, which will automatically adjust the SOV supply to prevent excessive price volatilities.

32. A high SOV price would boost potential revenue gains, but would imply greater risk of monetary instability. The law allows for 2.4 million SOV units to be vested annually in the Resident-Citizen Allocation Fund, at a rate of 20 percent per year over 5 years. If the SOV in the Resident-Citizen Allocation Fund was distributed to the public immediately on being vested, it could represent a sizable monetary expansion akin to "helicopter money" depending on the SOV exchange rate.³⁰ For example, if the SOV price successfully reached the ICO target of \$50, there could be a transfer to households of about 11 percent of GDP per year over the next five years.³¹ The implied transfer of purchasing power could require a sizable reduction in other government spending to prevent an unsustainable increase in aggregate demand. On the other hand, if the SOV price was low, or if SOV were retained in the trust funds, the impact on monetary conditions could be more limited.

Other Risks and Challenges

33. The SOV arrangement creates risk of strong third-party dependencies for RMI, including the potential outsourcing of core functions such as monetary policy. The government will delegate the issuance and initial management of the SOV to a third party. While the third party will bear the costs of launching the SOV, it will also receive half of the initial SOV issuance. The dual role of issuer and private investor may create the appearance of a conflict of interest that a central bank would not have. The SOV arrangement creates risk of strong third-party dependencies for the RMI, including the potential outsourcing of core functions such as monetary policy that are typically sovereign concerns.

34. Like other virtual currencies/crypto assets, the SOV would face cyber risks which, at the moment, do not appear to be mitigated. Control over the SOV and cybersecurity will be key to the success of the SOV. Considering the legal status of the SOV and the fact that half of the SOV at issuance will be allocated to the RMI population (directly or indirectly, through the allocation to various trust funds), ensuring the security of the protocol will be crucial. As indicated above,

³⁰ The SOV Act does not specify when SOV units held in the Resident-Citizen Allocation Fund will be distributed to the public.

³¹ As 20 percent of 2.4 million SOV is 0.48 million SOV units, which at \$50 each would amount to \$24 million, or roughly 11 percent of 2018 GDP.

however, the development (and future maintenance) of the SOV protocol has been entirely delegated to the appointed organizer – the authorities have no control over the protocol and its development. They have no means of ensuring that it is safe.

35. This exposes the RMI government to risks, the legal consequences of which are unclear. In addition to the lack of control over the SOV, little consideration has been given to the legal consequences of a potential breach of the protocol. For example, it is not clear whether the RMI population – who, pursuant to the law, is entitled to a share of the SOVs – will have a right of recourse if the SOVs are stolen prior to distribution. Also, little consideration appears to have been given to other aspects of the use of the SOV, such as whether it will be available for loan transactions.

36. The issuance of the SOV would also present reputational risk to the RMI. The intention is that the SOV would have a first-mover advantage over other attempts to establish a crypto asset as legal tender. However, assuming that the issues discussed above are resolved and the SOV is accepted in foreign jurisdictions, there is no guarantee that any first-mover advantage would accrue to SOV as other virtual currencies are developed. Moreover, the risks involved affect the RMI's reputation for having a sound regulatory environment, with potential consequences for the ease with which financial intermediaries may operate within the RMI.

F. Conclusion

37. Considering the significant risks and challenges, staff recommends that the authorities seriously reconsider the issuance of the SOV as legal tender. Given the absence of a common regulatory approach to virtual currencies/crypto assets worldwide, the SOV will be exposed to significant regulatory arbitrage. Unless strong AML/CFT measures are implemented, the issuance of the SOV will expose the RMI's financial system and economy to potentially significant ML and TF risks, and will elevate the already high risks of losing the last U.S. dollar CBR. The SOV issuance in the absence of a monetary policy framework could also pose significant challenges to macroeconomic management. Finally, limited capacity and infrastructure within the RMI could be an important practical obstacle to the success of the SOV. As a result, the potential benefits from revenue gains appear considerably smaller than the potential costs arising from economic, AML/CFT, reputational, governance and legal risks.

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