United States Government Accountability Office

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Report to Congressional Committees

June 2007

COMPACTS OF FREE ASSOCIATION

Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income

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Accountability * Integrity * Reliability

GAO-07-513

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Highlights

Highlights of GAO-07-513, a report to congressional committees

Why GAO Did This Study

In 2003, the U.S. government extended its economic assistance to the Federated States of Micronesia (FSM) and Republic of the Marshall Islands (RMI) through Amended Compacts of Free Association. From 2004 to 2023, the United States will provide an estimated combined total of $3.6 billion, with annually decreasing grants as well as annually increasing contributions to trust funds for each country. The trust funds are to be invested and provide income for the FSM and RMI after the compact grants end. A trust fund committee for each country is to establish and oversee the funds. This report examines (1) the committees' progress in establishing, investing, and reporting on the funds; (2) the sustainability of income from the trust funds; and (3) potential options to supplement or enhance the trust funds' income. GAO reviewed trust fund–related documents and legislation; interviewed U.S., FSM, RMI, and industry officials and used a simulation model to project the trust funds' income.

What GAO Recommends

GAO recommends that the trust fund committees improve administrative and decision-making processes, ensure timely reporting, and obtain a full and independent evaluation of securitization's potential benefits and risks. Interior, which chairs the committees, agreed with all of the recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-513.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David Gootnick at (202) 512-3149 or gootnickd@gao.gov.

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What GAO Found

The FSM trust fund committee has established the fund by appointing a trustee, an auditor, an investment adviser, and money managers. As of the end of March 2007, the RMI committee had not appointed an auditor or a money manager. Investment of the funds began 22 months and 16 months, respectively, after the FSM's and RMI's initial contributions, with the funds remaining in low-interest savings accounts until their investment. Contractual delays contributed to the time taken to establish and invest the funds, as did the committees' processes for reaching consensus and obtaining administrative support; the committees have not yet taken steps to improve these processes. Although the committees are required to report annually on the trust funds, they did not publish reports for 2004 and were late in publishing the reports for 2005 and 2006. Moreover, the published reports do not assess the trust funds' potential effectiveness in helping the FSM and RMI achieve the compact goals of economic advancement and budgetary self-reliance.

The FSM and RMI trust funds may not provide sustainable income after the compact grants end. Market volatility, as well as the investment strategies chosen, may lead to a wide range of trust fund balances in 2023. There is increasing probability that in some years the trust funds will not reach the maximum disbursement level allowed—an amount equal to the inflation adjusted compact grants in 2023—or be unable to disburse any income. GAO's analysis shows low probabilities of not reaching the maximum level allowed or disbursing no income in 2024 but higher probabilities of not reaching the maximum level allowed in 2050. For instance, by 2050, with a conservative investment strategy, income from the FSM and RMI trust funds, respectively, is over 90 percent and 60 percent likely to be less than the maximum level allowed and more than 20 percent and 15 percent likely to allow for no disbursements.

The trust funds' income could be supplemented or enhanced through (1) greater tax revenue, (2) increasing remittances from growing emigration, (3) economic assistance from other sources, and, possibly, (4) securitization of the funds. However, limited development prospects constrain the countries' ability to raise tax revenues to supplement the trust fund income. In addition, FSM and RMI emigrants' inadequate education and vocational skills may limit their earning opportunities. Further, although the RMI trust fund received contributions from Taiwan, it is unclear whether the FSM trust fund will receive other contributions. Finally, although securitization—the issuing of bonds against future U.S. contributions—could increase the funds' earning potential by raising their balances, it could also lead to lower balances and reduced income. The committees have not yet obtained an independent evaluation of securitization's potential benefits and risks.

Contents

Letter		1
	Results in Brief	3
	Background	6
	Establishment of FSM Trust Fund Is Complete, but RMI Trust Fund Is Not Yet Fully Established	15
	FSM and RMI Trust Funds May Not Provide Sustainable Income after Compact Grants End	20
	Several Options Exist for Supplementing FSM and RMI Trust Fund Income	28
	Conclusions	32
	Recommendations for Executive Action	32
	Agency Comments and Our Evaluation	33
Appendix I	**Objectives, Scope, and Methodology**	36
Appendix II	**Technical Notes on the Trust Fund Simulation Model**	38
Appendix III	**Disbursing All Income Compared to Disbursing Partial Income**	48
Appendix IV	**Key Events in the Establishment of the FSM and RMI Trust Funds**	51
Appendix V	**Comments from the Department of the Interior**	53
	GAO Comment	56
Appendix VI	**Comments from the Department of Health and Human Services**	57
	GAO Comment	60
Appendix VII	**Comments from the Department of State**	62
	GAO Comments	65

Appendix VIII — Comments from the Federated States of Micronesia 67

Appendix IX — Comments from the Republic of the Marshall Islands 69
GAO Comments 72

Appendix X — GAO Contact and Staff Acknowledgments 73

Tables

Table 1: U.S. Assistance to the FSM and the RMI under Amended Compacts, Fiscal Years 2004-2023 7
Table 2: Annual Compounded Real Returns and Standard Deviations for Large Company and International Stocks and for U.S. Treasury Bills (in percentage), 1970-2005 14
Table 3: Possible Outcomes of Three Types of Investment Strategies, with Associated Real Returns and Standard Deviations 14
Table 4: Projected Trust Fund Balances in 2023 with and without Securitization, under Aggressive Investment Strategy 31
Table 5: U.S. Scheduled Contributions to FSM and RMI Trust Funds, as Outlined in Amended Compacts 38
Table 6: Taiwan's Scheduled Contributions to RMI Trust Fund, as Outlined in Agreement with RMI Government 39
Table 7: Real Returns Distribution Based on Historical Data from 1970 to 2005 42
Table 8: Cross-Correlation and Serial Correlation of Historical Annual Returns 43
Table 9: Trial Values of the FSM Trust Fund Balances under Moderate Investment Strategy, Fiscal Years 2006-2023 44
Table 10: Trial Values of the RMI Trust Fund Balance under Moderate Investment Strategy, Fiscal Years 2006-2023 46

Figures

Figure 1: Structure of FSM and RMI Trust Funds 10
Figure 2: Inflation-Adjusted Annual Returns of International and Large Company Stocks, 1970-2005 13

Figure 3: Timeline of Key Events in Establishment of FSM Trust Fund 16
Figure 4: Timeline of Key Events in Establishing the RMI Trust Fund 17
Figure 5: Projections of FSM Account Balance with Three Possible Investment Strategies 21
Figure 6: Projections of RMI Account Balance with Three Possible Investment Strategies 22
Figure 7: Probability of FSM Trust Fund Income Not Reaching the Maximum Disbursement Levels Allowed, Fiscal Years 2024 - 2050 24
Figure 8: Probability of No Disbursement from FSM Trust Fund, Fiscal Years 2024 - 2050 25
Figure 9: Probability of RMI Trust Fund Income Not Reaching the Maximum Disbursement Levels Allowed, Fiscal Years 2024 - 2050 26
Figure 10: Probability of No Disbursement from RMI Trust Fund, Fiscal Years 2024 - 2050 27
Figure 11: Probabilities That FSM Trust Fund Income Will Not Reach the Maximum Disbursement Level Allowed When Disbursing All Income vs. Disbursing Partial Income 49
Figure 12: Probabilities That RMI Trust Fund Income Will Not Reach the Maximum Disbursement Level Allowed When Disbursing All Income vs. Disbursing Partial Income 50
Figure 13: Key Events in the Establishment of the FSM Trust Fund 51
Figure 14: Key Events in the Establishment of the RMI Trust Fund 52

Abbreviations

FSM	Federated States of Micronesia
HHS	Department of Health and Human Services
RMI	Republic of Marshall Island

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Congressional Committees:

From 1987 to 2003,[1] the United States provided about $2.1 billion in economic assistance to the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) through a Compact of Free Association.[2] In 2003, the U.S. government extended its economic assistance to the FSM and the RMI governments through Amended Compacts of Free Association.[3] Under the amended compacts' terms, the United States will provide an estimated combined total of $3.6 billion in economic assistance to the FSM and the RMI from 2004 to 2023,[4] to assist the FSM and the RMI governments in their efforts to promote the economic advancement and budgetary self-reliance of their people. This assistance consists of annually decreasing grants targeted to certain development sectors and annually increasing contributions to a trust fund for each country, to which the FSM and the RMI are also to make initial contributions. The trust funds are to be invested, and after termination of annual U.S. grant assistance in 2023, annual disbursements of the investment earnings[5] are to provide an ongoing source of revenue to assist

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[1]In this report, all years cited are fiscal years (Oct. 1 - Sept. 30) unless otherwise noted.

[2]A key goal for this assistance was to advance the countries' economic development and budgetary self-reliance. In 2000, we reviewed the impact of compact funding and found that U.S. assistance had resulted in little economic development for either the FSM or the RMI. See GAO, *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development*, GAO/NSIAD-00-216 (Washington, D.C.: Sept. 22, 2000).

[3]Whereas the original compact (approved in Pub. L. No. 99-239, Jan. 14, 1986) was one agreement among the U.S., FSM, and RMI governments, the amended compacts (approved in Pub. L. No. 108-188, Dec. 17, 2003) are separate agreements between the United States and each of the two countries.

[4]The $3.6 billion in assistance includes (a) compact grants; (b) trust fund contributions; (c) Kwajalein impact funding provided to the RMI government, which in turn compensates Kwajalein Atoll landowners, for U.S. access to the atoll for military-purposes; and (d) estimated values of compact-authorized federal services such as weather, aviation, and postal services, at around $200 million over the 20-year period. Services associated with the Federal Emergency Management Agency have been excluded.

[5]The annual disbursements may not exceed the amounts, adjusted for inflation, that each country receives as grant assistance in 2023.

the FSM and the RMI in achieving economic advancement and long-term budgetary self-reliance.

The amended compacts and subsidiary trust fund agreements[6] require the formation of a trust fund committee for each country. Each committee is responsible for establishing the trust funds by, among other things, hiring trustees, independent auditors, investment advisers and money managers. The trust fund committees' responsibilities also include overseeing the funds' operation, supervision, and management; the funds' investment; and the conclusion of agreements with any other contributors to the funds.[7] The trust fund agreements do not specify a time frame for establishing and investing the funds. Within 6 months after the end of each fiscal year, the committees are to provide annual reports to the governments on the trust funds' activities, management, financial operations, and effectiveness at accomplishing the purposes of the funds. Each committee comprises representatives from the U.S. government, the country's government, and any subsequent contributors; a representative from the Department of the Interior (Interior) serves as the chair of each committee.

U.S. legislation approving the amended compacts requires that we report periodically to Congress on the status of compact implementation. In 2006, we provided two reports responding to this mandate.[8] This report provides additional information, examining (1) the trust fund committees' progress

[6]*Agreement Between the Government of the United States of America and the Government of the Federated States of Micronesia Implementing Section 215 and Section 216 of the Compact, as Amended Regarding a Trust Fund*; *Agreement Between the Government of the United States of America and the Government of the Republic of the Marshall Islands Implementing Section 216 and Section 217 of the Compact, as Amended Regarding a Trust Fund.*

[7]Contributors other than the U.S., FSM, and RMI governments may include any government, international organization, financial institution, or other entity or person who contributes grants, not loans, to the trust funds.

[8]GAO, *Compacts of Free Association: Development Prospects Remain Limited for Micronesia and Marshall Islands*, GAO-06-590 (Washington, D.C.: June 2006); *Compacts of Free Association: Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability*, GAO-07-163 (Washington, D.C.: Dec. 15, 2006). For an initial review of trust fund implementation, see GAO, *Compacts of Free Association: Implementation of New Funding and Accountability Requirements Is Well Under Way, but Planning Challenges Remain*, GAO-05-633 (Washington, D.C.: July 11, 2005).

in establishing,[9] investing, and reporting on the funds; (2) the sustainability of income from the trust funds after the compact grants end in 2023; and (3) other potential sources of revenue to supplement or enhance trust fund income after 2023.

Monte Carlo Simulation

Our methodology for projecting trust fund income is based on a technique known as the Monte Carlo simulation.This problem-solving technique approximates the probability of certain outcomes by performing multiple trial runs, called simulations, using random variables. The simulations capture the volatility of market returns and reflect that volatility in the projection of the future earnings of the trust funds.

GAO has used the Monte Carlo simulation in past reports, and it has also been used by the Congressional Budget Office in Social Security projections.

To answer these objectives, we reviewed the amended compacts, the trust fund agreements and bank statements as well as documents related to establishing the funds. We also reviewed documents related to the implementation of the trust fund agreements. We interviewed officials from U.S. government agencies, including Interior, the Department of State (State), the Department of Labor (Labor), and the Department of Health and Human Services (HHS), as well as officials from the FSM and the RMI. We interviewed the RMI's trustee and selected investment adviser. In addition, we built a Monte Carlo simulation model—based on the trust fund agreements, contributions to date, and historical returns of the market—to project the trust funds' likely income levels, given market volatility as well as historical returns of various asset classes, including large company stocks, treasury bills, and international stocks from 1970 to 2005. (Actual trust fund income will depend on the investment strategies chosen for the funds, market trends, and investment performance.) We also analyzed the probability that the trust funds can maintain the maximum disbursement level allowed under the trust fund agreements.[10] We conducted our work from July 2006 to March 2007 in accordance with generally accepted government auditing standards. (For more details of our objectives, scope, and methodology, see app. I.)

Results in Brief

The FSM trust fund committee has fully established the country's trust fund, but the RMI trust committee has not; further, investment of the funds was slow, and both committees missed the deadlines for submitting the required annual reports. The FSM committee has appointed a trustee, an independent auditor, an investment adviser, and money managers. As of March 2007, the RMI committee had not appointed an independent auditor

[9]In this report, "establishing the funds" refers to the selection and hiring of the trustees, independent auditors as well as the selection and hiring of any investment advisers and money managers.

[10]According to U.S. officials, the trust fund income is intended to be one source of income, and the amended compacts do not guarantee that the trust funds will provide the maximum disbursements allowed by the trust fund agreements. However, projections of the trust funds' ability to disburse the maximum allowed amounts can indicate the likely level and sustainability of the funds' income.

and—in part because the trustee and the investment adviser disagree over the assignment of custodial rights to the fund—had not appointed any money managers. Investment of the FSM and RMI trust funds began 22 months and 16 months, respectively, after the countries' initial contributions, with the funds remaining in low-interest savings accounts until their investment. According to U.S. government officials, unexpected contracting delays, as well as the trust fund committees' processes for reaching consensus and obtaining administrative support, contributed to slowing the funds' establishment. However, the committees have not taken steps to improve the processes. The committees did not meet the trust fund agreement requirements to submit and publish annual reports on the trust funds for 2004 and issued the reports for 2005 several months after the March 2006 deadline. Moreover, the reports do not assess the trust funds' likely effectiveness in helping the FSM and the RMI achieve economic advancement and long-term budgetary self-reliance by providing a source of revenue to the FSM and RMI governments after 2023.

Owing in part to market volatility, the FSM and the RMI trust funds may not provide sustainable income to the countries after annual compact grants end in 2023. Market volatility, in addition to the investment strategies chosen, may lead to a wide range of trust fund balances in 2023. For example, our analysis shows that the trust fund balance could range[11] from $697 million to $1.3 billion for the FSM and from $439 million to $862 million for the RMI under a conservative strategy, from $663 million to $2.2 billion for the FSM and from $438 million to $1.4 billion for the RMI under an aggressive strategy. Moreover, we found increasing probability that income from the trust funds cannot sustain the maximum disbursement level allowed—an amount equal to the compact grant assistance in 2023, adjusted for inflation. Furthermore, the trust funds face increasing probability of providing no income at all in some years. For instance, our analysis shows low probabilities that the trust funds will not reach the maximum allowed disbursement levels immediately after the compact grants end. However, by 2050, with a conservative investment strategy, income from the FSM and RMI trust funds, respectively, is more than 90 percent and 60 percent likely not to reach the maximum allowed

[11]The ranges referred to in this example are between the 10th and 90th percentile values from the results of our simulation model under different scenarios. Ten percent of the range of possible trust balances lie below the 10th percentile; 90 percent of the range of possible balances lie below the 90th percentile. See appendixes I and II for more information.

disbursement levels and more than 20 percent and 15 percent likely to allow for no disbursements.

The trust funds' income could be supplemented or enhanced through (1) greater tax revenue through economic development; (2) increasing remittances from growing numbers of emigrants;[12] (3) economic assistance from other sources; and (4) securitization of the funds.[13] However, each of these scenarios has its limitations.

- *Greater tax revenue.* Economic development could increase the FSM and the RMI governments' tax revenue. However, as we reported in 2006, the countries' prospects for economic development and higher tax revenues remain limited.
- *Growing emigration and remittances.* As compact grant assistance decreases, emigration from the FSM and RMI may rise, easing the governments' cost of providing services to remaining residents and possibly leading to growing remittances from the emigrants. However, FSM and RMI emigrants have limited earning opportunities abroad, owing to inadequate education and vocational skills, and may therefore not remit significant amounts.
- *Assistance from other sources.* The RMI trust fund received a commitment from Taiwan to contribute $40 million over 20 years to the RMI trust fund, which improved the RMI fund's likely capacity for disbursements after 2023. However, except for Taiwan's commitment to the RMI, there is no certainty of external trust fund contributions other than those from the United States. Further, although donors other than the United States have given the two countries economic assistance unrelated to the trust funds, such assistance is not assured for the future.
- *Securitization.* Although securitizing the trust funds—that is, issuing bonds against future U.S. contributions—could increase the funds' earning potential by raising their balances, it could also lead to lower balances and reduced income. According to Interior officials, the trust fund committees

[12]Remittances are personal funds that emigrants voluntarily send to residents in their home countries.

[13]With securitization, the trust funds would sell bonds to investors and the cash generated through bond issuance would become the trust fund principal to be invested. Future contributions to the trust fund would be used to pay bond holders instead of building the funds. Securitization could help increase the principal of the trust fund more quickly than would annual contributions to the fund.

are reviewing this option but have not initiated an independent study to objectively evaluate its potential risks.

In this report, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the FSM and the RMI trust fund committees, to develop strategies for improving the committees' decision-making and administrative processes; ensure timely reporting of trust fund activities, including assessment of the funds' likely status as an ongoing source of revenue and their potential effectiveness in helping the FSM and the RMI achieve economic advancement and budgetary self-reliance; and obtain an independent evaluation of the potential benefits and risks of securitization.

Interior, HHS, State, and the FSM and the RMI governments provided written comments regarding a draft of this report. Interior, HHS, and the RMI government agreed with our recommendation on developing strategies for improving the trust fund committees' decision-making and administrative processes. Interior generally agreed with our recommendation on ensuring timely reporting of trust fund activities. However, HHS and State stated that our report reflected a fundamental misunderstanding of the outcome of the negotiation of the amended compacts and a misreading of the international agreements, which we strongly disagree. Our report clearly stated that the purpose of the trust funds is to provide an ongoing source of revenue. To further clarify this point, we modified our recommendation and added language specifying that there is no minimum disbursement required or guaranteed by the trust fund agreements. Interior, HHS, and the RMI government agreed with our recommendation on obtaining an independent evaluation of the potential benefits and risks of securitization. The FSM government generally agreed with all of our recommendations. State did not provide any comment about our recommendations.

Background

The U.S. trust fund agreements with the FSM and the RMI state that the purpose of the trust funds is to contribute to the countries' economic advancement and long-term budgetary self-reliance by providing an annual source of revenue after fiscal year 2023.[14] Annual compact grants end in

[14]The trust fund income is intended to provide assistance in development sectors currently receiving grants under the amended compacts: education, health, infrastructure, private sector development, the environment, and public sector capacity building, with priority given to education and health. The income may also be used for other sectors mutually agreed to by the United States and the countries.

2023. Although the agreements state that the annual disbursements may not exceed the amounts that each country receives as grant assistance in 2023, adjusted for inflation, they do not establish or guarantee a minimum disbursement level.

Trust Fund Contributions

Under the amended compacts, annual U.S. contributions to each of the countries' trust funds increase by the same amounts as the annual grants to the countries decrease; in addition, the contributions are partially adjusted for inflation. (See table 1.) However, the scheduled trust fund increments and grant decrements for the two countries differ: the grant decrement and trust fund increment for the FSM is $800,000 per year, and the grant decrement and trust fund increment for the RMI is $500,000 per year. The timing of the first decrement for each country also differs: under the amended compacts, the decrement for the FSM began in 2007, but the decrement for the RMI began in 2005. As a result of these differences, final grants to the FSM will decline from the initial grants by a smaller total percentage than will grants to the RMI (18 percent versus 21 percent).

Table 1: U.S. Assistance to the FSM and the RMI under Amended Compacts, Fiscal Years 2004-2023

Dollars in millions

	Annual grants contribution		Trust fund contribution	
Fiscal year	**FSM**	**RMI**	**FSM**	**RMI**
2004	$76.2	$35.2	$16.0	$7.0
2005	76.2	34.7	16.0	7.5
2006	76.2	34.2	16.0	8.0
2007	75.4	33.7	16.8	8.5
2008	74.6	33.2	17.6	9.0
2009	73.8	32.7	18.4	9.5
2010	73.0	32.2	19.2	10.0
2011	72.2	31.7	20.0	10.5
2012	71.4	31.2	20.8	11.0
2013	70.6	30.7	21.6	11.5
2014	69.8	32.2	22.4	12.0
2015	69.0	31.7	23.2	12.5
2016	68.2	31.2	24.0	13.0
2017	67.4	30.7	24.8	13.5
2018	66.6	30.2	25.6	14.0

Dollars in millions				
	Annual grants contribution		Trust fund contribution	
Fiscal year	**FSM**	**RMI**	**FSM**	**RMI**
2019	65.8	29.7	26.4	14.5
2020	65.0	29.2	27.2	15.0
2021	64.2	28.7	28.0	15.5
2022	63.4	28.2	28.8	16.0
2023	62.6	27.7	29.6	16.5
Total	**$1,401.6**	**$629.0**	**$442.4**	**$235.0**

Source: Compact of Free Association Amendments Act of 2003 (Pub. L. No. 108-188).

Note: These dollar amounts will be adjusted each year for inflation by a percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any one year, using the beginning of 2004 as a base. Both grant funding and trust fund contributions can be fully adjusted for inflation after 2014 under certain U.S. inflation conditions.

The U.S. contributions to the trust funds are conditioned on the FSM and the RMI making their own required contributions. The FSM was required to contribute at least $30 million before September 30, 2004; the FSM made this contribution on October 1, 2004, and the United States made its first contribution on October 5, 2004. The RMI was required to contribute at least $25 million on the day the amended compact went into effect or on October 1, 2003, whichever was later; $2.5 million before October 1, 2004; and an additional $2.5 million before October 1, 2005. The RMI made its initial contribution on June 1, 2004, and the United States made its initial contribution on June 3, 2004.

According to the U.S. trust fund agreements with the FSM and the RMI, contributions from other donors are permitted. In May 2005, Taiwan and the RMI reached an agreement that Taiwan will contribute a total of $40 million to the RMI's trust fund from 2004 to 2023.

Trust Fund Structure

As specified in the trust fund agreements, each country's trust fund consists of three interrelated accounts, labeled "A," "B," and "C."[15]

[15] A "D" account may be established to hold any contributions by the FSM and the RMI governments of revenue or income from unanticipated sources. According to the trust fund agreements, the D account must be a separate account, not mixed with the rest of the trust fund; it is not part of the corpus of the trust fund. As of March 2007, only the RMI had a D account, governed by the agreement between Taiwan and the RMI. Taiwan will contribute $10 million to the RMI's D account in 5 years.

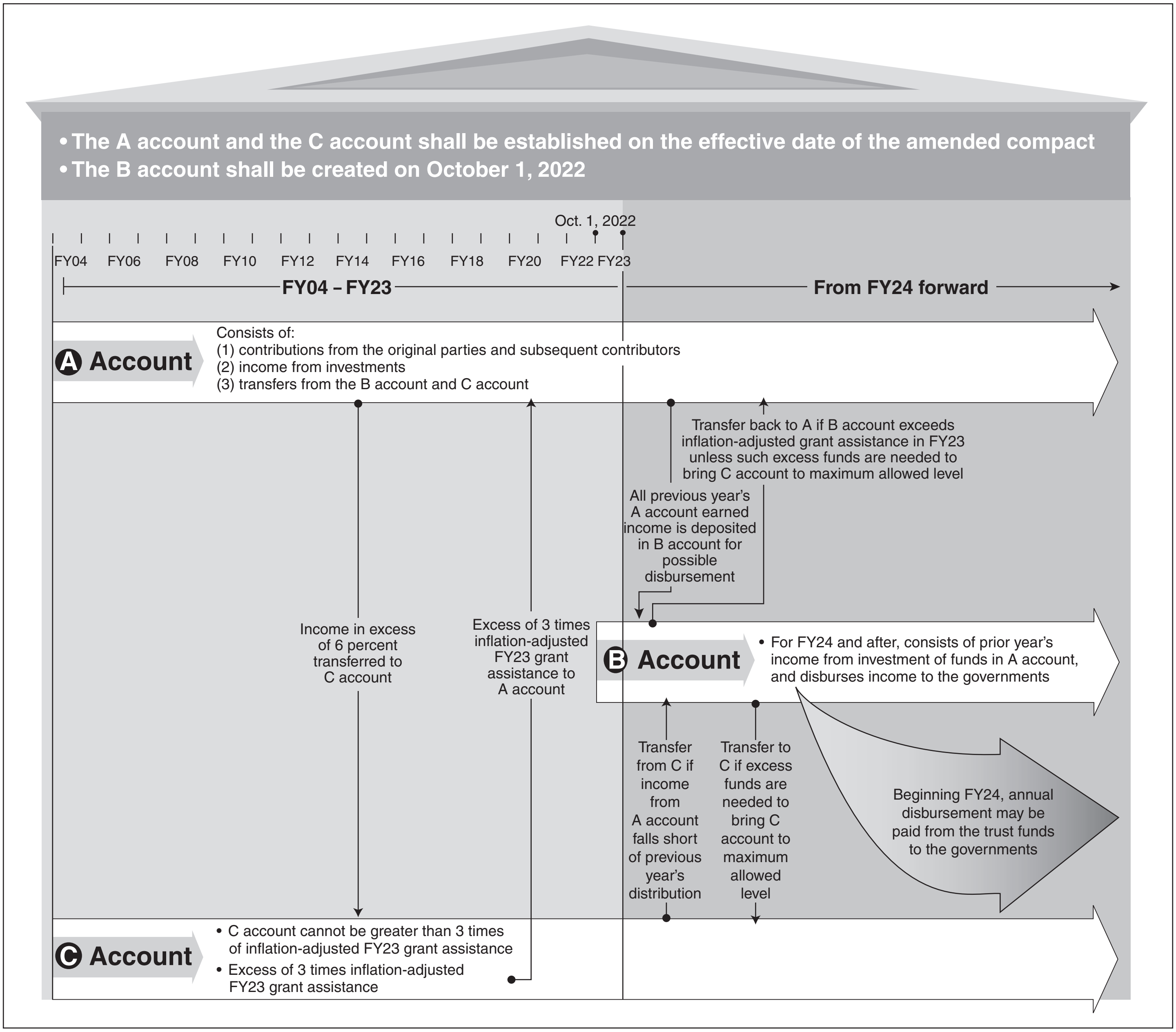
- The A account, which was to be created on the amended compacts' effective date, forms the trust fund "corpus"[16] and contains the country's initial contributions as well as the annual U.S. contributions. It also holds any contributions from other donors, such as Taiwan's to the RMI. The A account additionally consists of income from the trust fund's investment. Through 2022, any annual investment income exceeding 6 percent of the fund will be deposited in the C account, up to a certain limit. After 2023, if the income in the B account is less than the previous year's distribution, and if the C account cannot cover the shortfall in the B account, the corpus shall not be accessed to compensate for the shortfall.

- The B account, which is to be created at the start of fiscal year 2023, will be used to disburse income after the compact grants end. All annual investment income earned in 2023 will be deposited in the B account for possible disbursement in 2024. Thereafter, the B account will consist of the prior year's investment income in the A account. The annual disbursement from the B account may equal, but not exceed, the inflation-adjusted grant assistance in 2023 plus any additional amounts for special needs agreed to by the trust fund committee. Any amount exceeding the annual disbursement will be transferred back to the A account or—if the C account contains less than three times the estimated equivalent of 2023 grant assistance, including estimated inflation—transferred to the C account to bring it to the maximum level allowed.

- The C account, which was to be created at the same time as the A account, is designed as a buffer against low or negative annual investment returns after 2023. During the period before disbursements begin, any annual income on the fund exceeding 6 percent will be deposited in the C account; however, the C account cannot exceed three times the estimated grant assistance in 2023, including estimated inflation. After 2023, if annual income from the A account falls below the previous year's distribution, adjusted for inflation, the C account can be drawn down to address any shortfall in the B account.

[16] According to the trust fund agreements, "corpus" means a collection of bonds, stocks, or other holdings that form the principal of the trust fund. It also includes all accumulated income that has been reinvested and is not available for distribution.

Figure 1: Structure of FSM and RMI Trust Funds



Source: GAO.

Trust Fund Governance

The trust funds, incorporated in the District of Columbia as nonprofit corporations, are governed by the FSM and the RMI trust fund committees, with the United States holding the majority of votes and the Deputy Assistant Secretary of the Interior, Office of Insular Affairs, serving as the chair of each committee.[17] The committees' responsibilities[18] include establishing the funds as well as overseeing their operation, supervision, and management; investing and distributing the fund's resources; and concluding agreements with any other contributors and other organizations.

According to the trust fund agreements, each trust fund committee is to appoint a trustee and an independent auditor. In addition, the committee has the authority to appoint one or more investment advisers and may enter into a separate agreement with one or more money managers.

- The **trustee**[19] is to have the entire care and custody of all assets comprising the trust fund. The trustee's duties and powers include collecting money due to the fund, disbursing income in accordance with the trust fund agreement, and maintaining records of all financial transactions related to the fund.
- The **independent auditor** is to audit the trust fund from its establishment through 2023 at appropriate intervals and annually after 2023.
- The **investment adviser** is responsible for recommending one or more money managers who will invest the assets of the fund to produce a diversified portfolio, take direction from the trust fund committee regarding investments, and oversee day-to-day investments by the money manager.

[17]Except for where stated otherwise in the agreement, trust fund committee decisions are made by a majority vote. The FSM trust fund committee has five voting members: three from the United States (Interior, State, and HHS) and two from the FSM. The RMI trust fund committee has seven voting members: four from the United States (Interior, State, HHS, and Labor); two from the RMI; and one from the other contributor, Taiwan.

[18]Each agreement states that either the U.S. government, in consultation with the FSM or the RMI government, or the trust fund committee, if it is operational when the amended compact takes effect, is responsible for establishing the trust fund. (In this case, "establishing the trust fund" refers to the incorporation of the fund rather than to the selecting and hiring of the trustee, auditor, investment adviser, and money manager, as the phrase is otherwise defined in this report.)

[19]The trust fund agreements states that the trustee shall (a) be selected from among trust institutions organized in the United States, (b) have a net worth in excess of $100 million, (c) have at least 10 years experience as a custodian of financial assets, and (d) have experience in managing trust funds of at least $500 million.

- The **money manager** is to invest the funds in particular investment vehicles or categories.

The trust fund agreements do not specify a time period for selecting these entities.

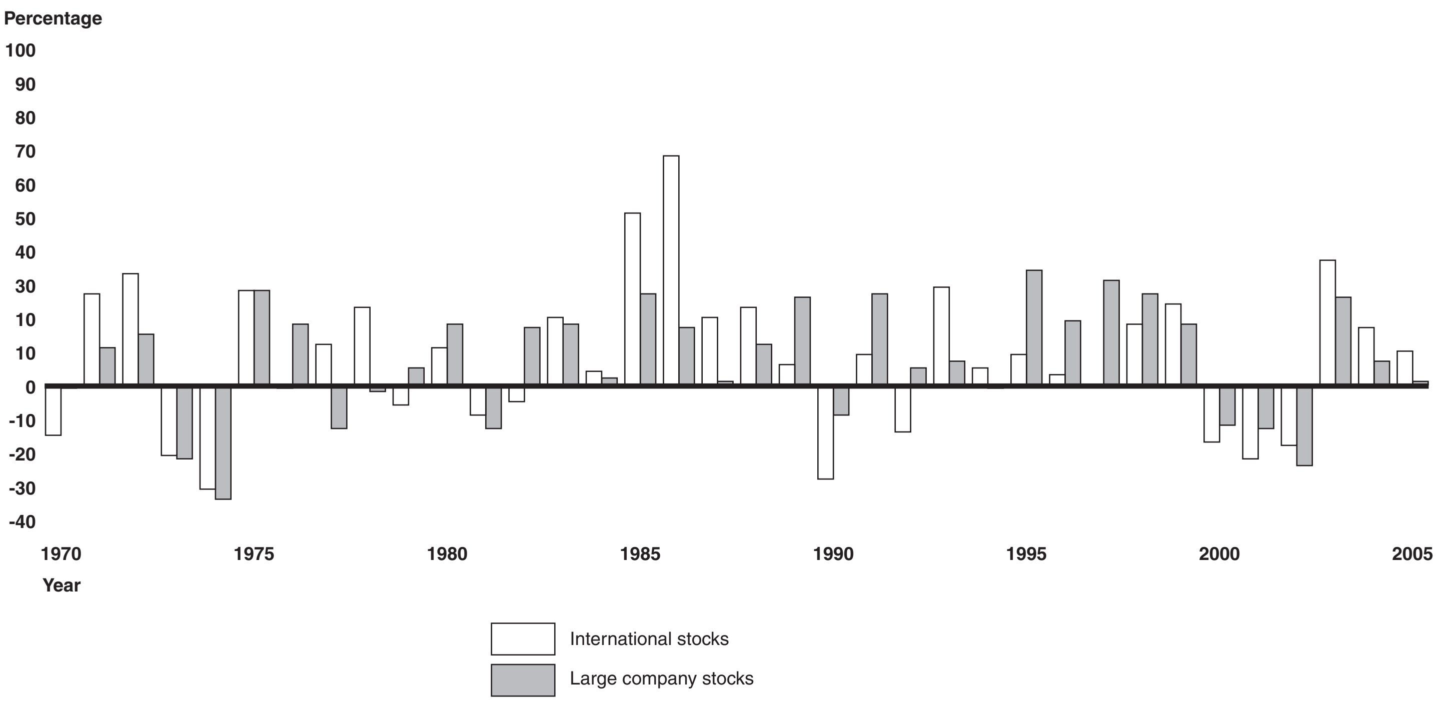
In addition, the committees are responsible for publishing annual reports on the trust funds and submitting the reports to the governments of United States and the FSM or the RMI within 6 months after the end of each fiscal year—that is, by the end of the following March. These reports are to describe the activities and management of the funds, including the operation of the A, B, and C accounts, and to contain audited account information and the audit reports. The reports are also to assess the effectiveness of the funds in contributing to the economic advancement and long-term budgetary self-reliance of the FSM and RMI. The reports may include recommendations to improve the effectiveness of the funds.[20]

Investment Returns and Volatility

Because the level of income that the trust funds will generate depends on investment returns, it is subject to market volatility. Historically, the stock market has experienced fluctuations. For example, from 1970 to 2005, annual inflation-adjusted returns of U.S. large-company stocks ranged from negative 34 percent to positive 34 percent, and annual real returns from international stocks ranged from negative 31 percent to positive 68 percent (see fig. 2). With positive returns, the trust funds will earn investment income, and with negative returns, the value of the trust funds will fall.

[20]In addition, Pub. L. No. 108-188 requires the President to report annually to Congress regarding the FSM and the RMI, including information on non-U.S. contributions to the trust funds and, if appropriate, making recommendations to Congress to adjust the inflation rate or to adjust contributions to the trust funds based on non-U.S. contributions.

Figure 2: Inflation-Adjusted Annual Returns of International and Large Company Stocks, 1970-2005



Source: GAO analysis based on IBBOTSON 2006 Yearbook.

Note: The returns were published in Stocks, Bonds, Bills and Inflation (SBBI) 2006 Yearbook, Ibbotson Associates, Chicago, Illinois. The inflation-adjusted returns are the geometric difference between the nominal return and the inflation rate. Our calculation is based on returns in calendar years (Jan. 1 – Dec. 31).

The annual compounded real returns[21] of large company stocks and international stocks from 1970 to 2005 were around 6 percent (see table 2), with standard deviations[22] of approximately three times the return for the large company stocks and more than three times the return for the

[21]To calculate the compounded real returns, we used the annual total nominal returns published in IBBOTSON Associates 2006 Yearbook and constructed the inflation adjusted returns, which is a geometric difference between the nominal return and the inflation rate. We then constructed the real and nominal return indexes with year end 1969 = $1.00 to calculate the annual compounded returns.

[22]Standard deviation is a statistical measure of how widely spread the distribution is from its mean. It is obtained by calculating the square root of the average of the squares of deviations around the mean of a set of data.

international stocks. U.S. treasury bills have the least volatility and the lowest returns, around 1 percent.

Table 2: Annual Compounded Real Returns and Standard Deviations for Large Company and International Stocks and for U.S. Treasury Bills (in percentage), 1970-2005

	Large company stocks	International stocks	U.S. Treasury bills
Compounded real returns	6.12	6.18	1.27
Standard deviation	17.09	22.05	2.50

Source: GAO analysis of data from IBBOTSON Associates 2006 Year Book.

Note: Percentages shown are based on returns in calendar years (Jan. 1 – Dec. 31).

Investment strategies vary in their levels of returns and volatility. A more conservative investment strategy usually carries a lower level of volatility but also brings lower levels of expected returns over time; a more aggressive investment strategy seeks higher returns but is likely to have higher volatility, with returns on the investment varying more widely year to year. By varying the weight of each investment asset, investors can vary their return and risk levels. With the approach of 2024, when disbursements from the trust funds will begin, the portfolio can be adjusted to take on less risk. To illustrate possible outcomes of the trust funds' investment returns, table 3 shows potential returns for three types of investment strategies—conservative, moderate, and aggressive—based on historical annual compounded returns and volatility on large company stocks, international stocks, and treasury bills in 1970 to 2005.

Table 3: Possible Outcomes of Three Types of Investment Strategies, with Associated Real Returns and Standard Deviations

Strategy	Large company stocks	International stocks	Treasury bills	Return	Standard deviation
Conservative (Lower expected return/lower volatility)	40%	20%	40%	4.19%	10.48%
Moderate (Medium expected return/medium volatility)	40	40	20	5.17	14.18
Aggressive (Higher expected return/higher volatility)	50	50	0	6.15	17.53

Source: GAO analysis of data from IBBOTSON Associates 2006 Year Book.

Note: Percentages shown are based on returns in calendar years (Jan. 1 – Dec. 31).

Establishment of FSM Trust Fund Is Complete, but RMI Trust Fund Is Not Yet Fully Established

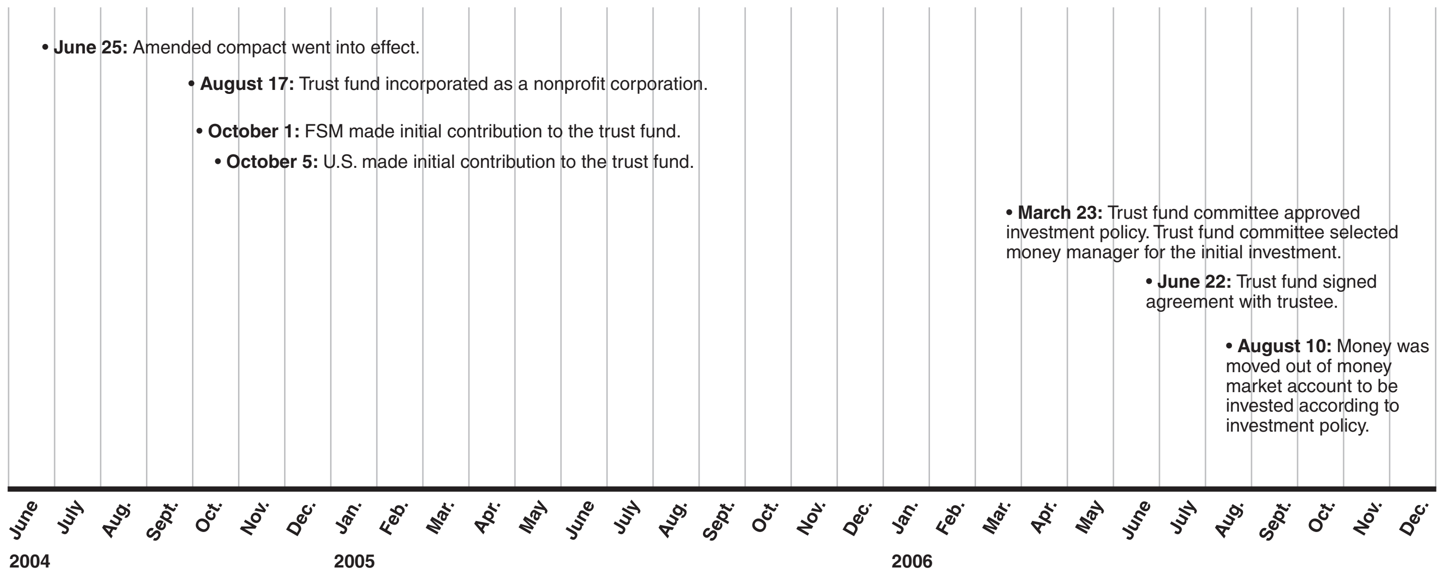
The FSM trust fund committee has appointed a trustee, an independent auditor, an investment adviser, and money managers; investment of the FSM trust fund began 22 months after the country's contribution. The RMI trust fund committee has appointed a trustee and an investment adviser, but as of March 2007, it had not yet appointed an auditor— in part because of disagreement between the trustee and investment adviser over the assigning of custodial rights—nor had it appointed a money manager. Investment of the RMI's trust fund began 16 months after the country's initial contribution. Unexpected delays related to contractual problems and trust fund committee processes contributed to the time that elapsed between the countries' initial contributions and the investment of the funds. Moreover, the period of time that the funds remained in low-interest accounts before their investment may have reduced potential investment earnings, particularly for the FSM. The committees did not meet the trust fund agreements' requirements to submit and publish annual reports on the funds for 2004 and were late in publishing the 2005 and 2006 reports. Moreover, the reports did not assess the trust funds' potential status as an ongoing source of revenue or effectiveness in helping the FSM and the RMI achieve economic advancement and long-term budgetary self-reliance.

Trust Fund Committees Have Taken Steps to Establish and Invest the Funds

The FSM trust fund committee has appointed a trustee, an independent auditor, an investment adviser, and money managers. The RMI trust fund committee has not officially appointed an auditor or a money manager. Investment of the funds began in August 2006 and September 2005, respectively.

- *FSM.* The FSM trust fund committee hired a trustee, an auditor, an investment adviser, and a money manager 24, 33, 16, and 21 months, respectively, after the amended compact went into effect. Investment of the FSM trust fund, according to its adopted investment policy, did not begin until August 2006, nearly 2 years after the FSM's initial contribution to the trust fund. Figure 3 provides a timeline of key events in setting up the FSM trust fund. (For details about this timeline, see app. IV).

Figure 3: Timeline of Key Events in Establishment of FSM Trust Fund



Source: GAO.

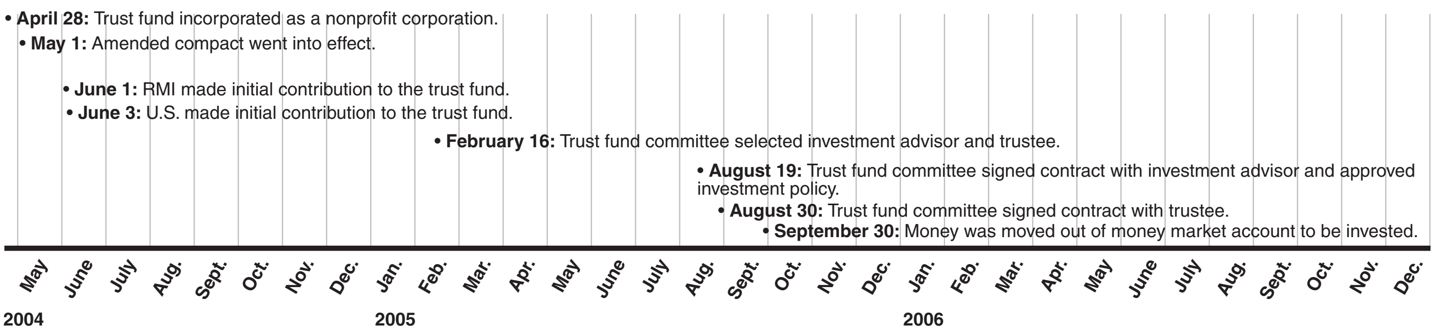
Note: The years shown are calendar years (Jan. 1 – Dec. 31).

- *RMI*. The RMI trust fund committee hired its current trustee and investment adviser in August 2005, 16 months after the amended compact went into effect. However, as of March 2007, the committee had not yet hired an independent auditor. In addition, owing to a disagreement between the trustee and the adviser over the assigning of custodial rights, the committee had not yet hired money managers to actively invest the funds according to the proposed investment strategy.[23] The trust fund agreements state that the trustee shall have the entire care and custody of all assets comprising the fund, however, the investment adviser has requested "subcustody" to allow it to better monitor the money managers' adherence to the investment strategy. The RMI trustee has not agreed to this arrangement, stating in a letter to the trust fund committee chairman that the trust fund agreement does not allow such an arrangement without legislation to amend the trust fund agreement. U.S. officials told us that they had been searching for a resolution of this dispute. Although the RMI made its first contribution of $25 million in June 2004, a month after the trust fund agreement went into effect, the country did not make its second contribution until February 2005—almost 5 months after the deadline—

[23]The adviser has not billed the committee as of March 2007.

when it contributed $1.5 million, which was $1 million less than required.[24] The RMI government explained that it faced various financial challenges in 2005, including the cost of upgrading infrastructure at the College of the Marshall Islands.[25] The committee transferred the RMI trust fund from low-interest bank accounts and began to invest it at the end of September 2005, 16 months after the initial contribution to the trust fund. In May 2005, Taiwan contributed $1 million to help fulfill RMI's second contribution requirement, and in October 2005, the RMI made the final contribution of $2.5 million. Figure 4 provides a timeline of key events in setting up the RMI trust fund. (For details of the timeline of key events, see app. III.)

Figure 4: Timeline of Key Events in Establishing the RMI Trust Fund



Source: GAO.

Note: The years shown are calendar years (Jan. 1 – Dec. 31).

Several Factors Slowed Establishment of the Funds

Unexpected contractual delays, as well as the trust fund committees' decision-making and administrative processes, slowed the committees' establishment of the funds.

- *Contractual delays.* Unexpected contractual delays slowed the FSM and the RMI trust fund committees' establishment of the funds. For example, according to an Interior official, the trustee chosen by the FSM trust fund committee provided the wrong template for its contract with the

[24]The amended compacts required the RMI to contribute at least $25 million on the effective date of the trust fund agreement or in October 2003, whichever was later; $2.5 million prior to October 1, 2004; and $2.5 million prior to October 1, 2005.

[25]The College of the Marshall Islands has experienced accreditation problems since 2003. According to the President of the college, the accreditation committee requires evidence that the college's physical infrastructure will be substantially upgraded. The RMI government had to find funding for the needed improvements and now has a plan for improving the college's infrastructure.

committee, with the result that finalizing the contract took extra time. Also, a disagreement over fees between the RMI trust fund committee and its initially selected trustee led the committee to select another trustee, delaying the RMI's contracting with a trustee.

- *Trust fund committee processes.* Delays related to certain trust fund committee processes also contributed to the time required to establish the funds. The U.S. members make it a practice to convene to reach consensus before attending full committee meetings. However, according to an Interior official, difficulty in convening all U.S. members has often delayed full committee meetings for months. Also, Interior noted that the trust fund committees' reliance on U.S. government staff for administrative support slowed committee processes. U.S. government employees have undertaken administrative functions for the trust funds in addition to their other duties. Interior, which has provided administrative support for the trust funds, has advocated that the trust funds hire their own support staff;[26] however, State has argued that after the trust funds are fully established, such positions would not be needed and would result in unnecessary costs. Some trust fund committee officials acknowledged that the committee processes have slowed the funds' establishment. However, the committees have not developed strategies to improve the consensus process and have not reached agreement about whether they should hire outside administrative assistance to improve committee performance.

Timing of Trust Fund Investment Reduced Potential Earnings

Although the trust fund agreements do not set a time frame for investing the funds, the months when the funds remained in low-interest accounts prior to investment may have reduced their potential investment earnings. However, the reduction in potential earnings was significant only for the FSM trust fund.

- *FSM.* For several months before the FSM trust fund was invested, stock market returns were notably higher than the interest that the fund earned in the low-interest savings account. From October 2005 through August 2006, the FSM trust fund—with an October 2005 balance of approximately $80 million—earned about 3 percent interest, compared with potential stock market earnings of about 15 percent. The difference between the fund's actual and potential monthly rates of return was about nine-tenths of a percentage point, amounting to approximately $720,000 per month,

[26]Interior believes that an administrative support position is allowed under the trust fund agreements and its cost can be covered by the trust funds.

taking into account stock market investment fees. After the FSM's Office of the Public Auditor issued a report evaluating the trust fund committee's compliance with the administrative requirements of the trust fund agreement,[27] the FSM government expressed concerns over the reduced income resulting from the fund's remaining in the savings account.

- *RMI.* For the months before the investment of the RMI trust fund's approximately $49 million in October 2005, the fund earned a return of approximately 3 percent, compared with a stock market return of about 4 percent. Given the small difference in returns, as well as the fees that the fund would have paid if invested in the stock market, the reduction in the RMI trust fund's potential income was small. We estimate that the delay in the RMI's final contribution to the fund reduced its earnings by approximately $51,000.[28]

Trust Fund Committees Did Not Publish Annual Reports as Required

Neither trust fund committee provided an annual report to the U.S. and FSM or RMI governments as required in the first year after the compacts took effect, and both committees were late in submitting the second year's reports.[29] According to the trust fund agreements, the committees are to prepare a report for each fiscal year and submit it to both the U.S. and the FSM or RMI governments by the end of the following March. However, neither committee submitted a report for fiscal year 2004, instead submitting one report for both 2004 and 2005. Additionally, the FSM and the RMI committees submitted these reports several months after the March 2006 deadline, in July 2006 and August 2006, respectively. Moreover, the reports do not project the likely status of the trust funds as an ongoing source of revenue or assess the funds' potential effectiveness

[27]FSM Office of the Public Auditor, *Inspection of the Compact Trust Fund: Period Covering August 2004 until May 2006* (Pohnpei, FSM, 2006).

[28]To estimate the RMI's income loss from late contributions, we calculated (a) the lost interest income on $25 million between May 2004, the contribution deadline, and June 2004, when the RMI made its first contribution; (b)the lost interest income on $2.5 million between October 2004, when the RMI was supposed to make its second contribution, and February 2005, when it made a partial contribution; and (c) the lost interest income on $1 million between February 2005, when the RMI contributed $1.5 million for its second contribution, to May 2005, when the RMI contributed the remaining $1 million. We used the actual interest rate the RMI trust fund earned during the period.

[29]The International Monetary Fund (IMF) has called for disclosing publicly the objectives and performance of the trust fund in line with the IMF guidelines for a transparent framework to ensure accountability and clarity of the trust fund management activities and results. See International Monetary Fund, *RMI: Selected Issues and Statistical Appendix*, IMF Country Report No. 06197 (Washington, D.C.: March 2006).

in helping the countries achieve economic advancement and budgetary self-reliance.[30] Because the trust fund income will be a main source of U.S. assistance to the FSM and the RMI after the amended compact grants end, its level has implications for the economic policies of both countries. For example, if trust fund income is expected to be inadequate to replace the expiring grants, the countries will have a greater need to develop other sources of revenue to help fund government operations.

FSM and RMI Trust Funds May Not Provide Sustainable Income after Compact Grants End

The FSM and the RMI trust fund income will likely not reach the maximum allowed disbursement levels after the compact grants end in 2023, with the probability of not reaching the maximum allowed level increasing over time.[31] Variable market returns, as well as the investment strategy chosen, could lead to a wide range of potential trust fund balances in 2023. Moreover, market volatility could contribute to not reaching the maximum level allowed, including the possibility of no disbursements in some years.[32]

Market Volatility Could Lead to Wide Range of Trust Fund Balances in 2023

Given historical market returns and volatility, the trust funds' likely balances in 2023 fall into a wide range, with a more aggressive strategy leading to higher expected balances but also a wider range of possible

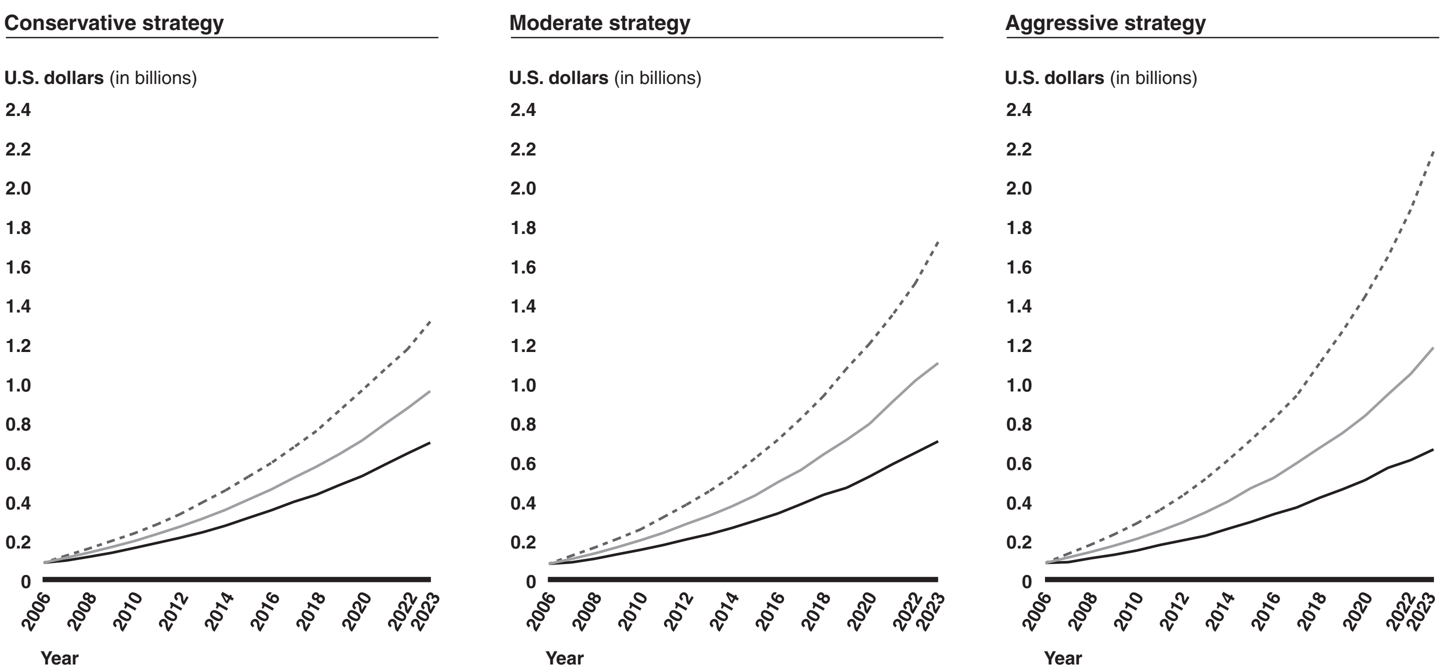
[30]This information could be included in the President's annual reports to Congress required by Pub. L. No. 108-188. The legislation does not require that information such as projections of trust fund balances be included in the reports. However, its inclusion would provide additional insight regarding the FSM's and RMI's progress in formulating economic policies to achieve economic advancement and budgetary self-reliance, to which the trust funds are intended to contribute by providing a source of revenue to the FSM and the RMI after 2023. The level of the trust fund income is directly related to its effectiveness in helping the countries achieve self-reliance: the higher the trust fund income, the more likely the countries will be self-reliant.

[31]The probability that disbursements will not reach the maximum disbursement level allowed depends on the actual approved disbursement levels. For example, if the trust fund committees do not disburse all earned income and instead reinvest part of the income, the probability of disbursements not reaching the maximum disbursement level allowed will differ from the probabilities presented below. (For a comparison of the probabilities of disbursements not reaching the maximum disbursement level allowed with and without full disbursement, see app. III.)

[32]In addition to market volatility, the amount of contributions to the trust funds plays an important role in determining whether the trust funds are able to provide sustainable income. Additional contributions to the funds improve the prospect of sustainability. For information on how Taiwan's contributions enhanced trust fund sustainability, see section on Economic Assistance from Other Donors.

balances (see fig. 5 and 6). For example, under our projected conservative strategy, in 2023, the FSM trust fund balance could range from $697 million (10th percentile) to $1.3 billion (90th percentile) with a median of $959 million; the RMI trust fund could range from $439 million (10th percentile) to $862 million (90th percentile) with a median of $612 million. Under our projected aggressive strategy, the FSM trust fund balance could range from $664 million (10th percentile) to $2.2 billion (90th percentile) with a median of $1.2 billion; the RMI trust fund balance could range from $438 million (10th percentile) to $1.4 billion (90th percentile) with a median of $778 million.

Figure 5: Projections of FSM Account Balance with Three Possible Investment Strategies

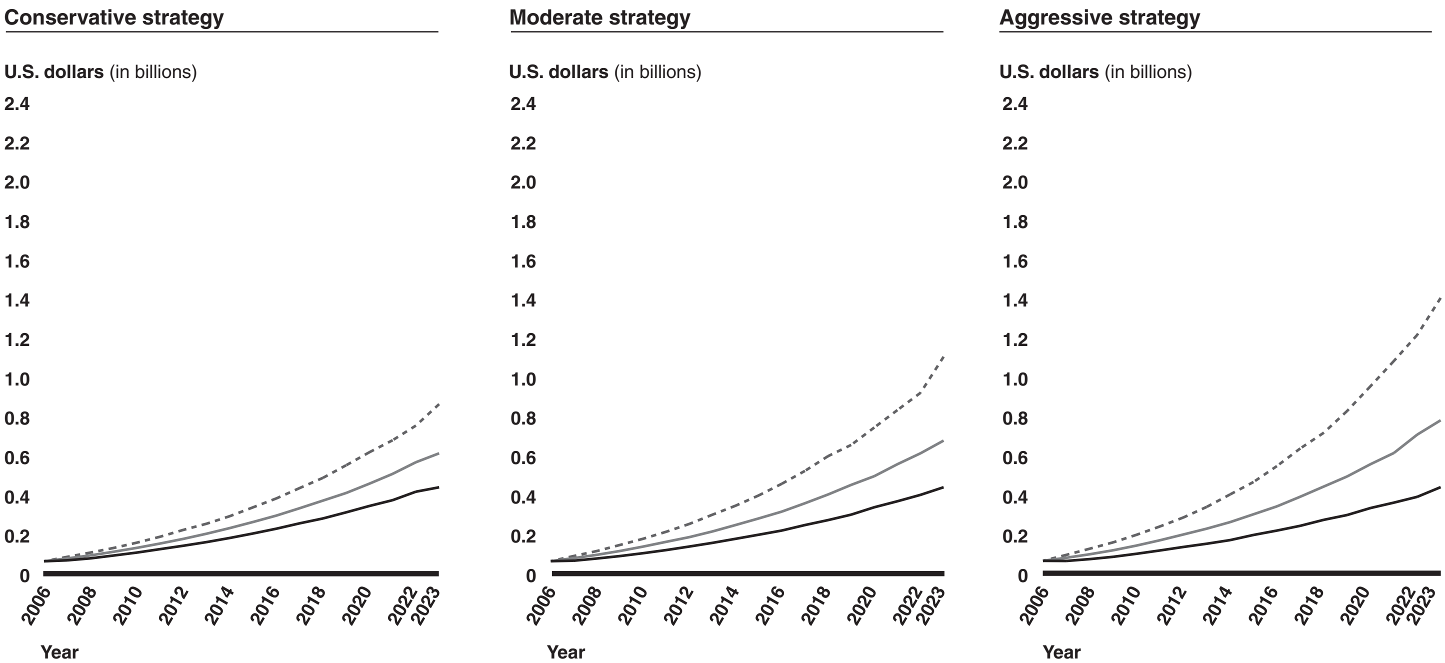


Trust fund balance in 2023	Conservative strategy	Moderate strategy	Aggressive strategy
10th percentile	$0.697	$0.710	$0.664
Median	0.959	1.108	1.182
90th percentile	1.313	1.724	2.179

10th percentile
Median
90th percentile

Source: GAO.

Figure 6: Projections of RMI Account Balance with Three Possible Investment Strategies



Trust fund balance in 2023	Conservative strategy	Moderate strategy	Aggressive strategy
10th percentile	$0.439	$0.439	$0.438
Median	0.612	0.676	0.778
90th percentile	0.862	1.103	1.401

10th percentile
Median
90th percentile

Source: GAO.

Trust Funds May Not Provide Sustainable Income after Compact Grants End

The FSM and the RMI trust funds may be unable to disburse the maximum level of income allowed in the trust fund agreements[33] or any income at all in some years.[34] Although each trust fund has a separate account to absorb some market volatility, our analysis shows there are some probabilities that income will not reach the maximum disbursement level allowed or that no income will be disbursed in some years, with the likelihood increasing with time.

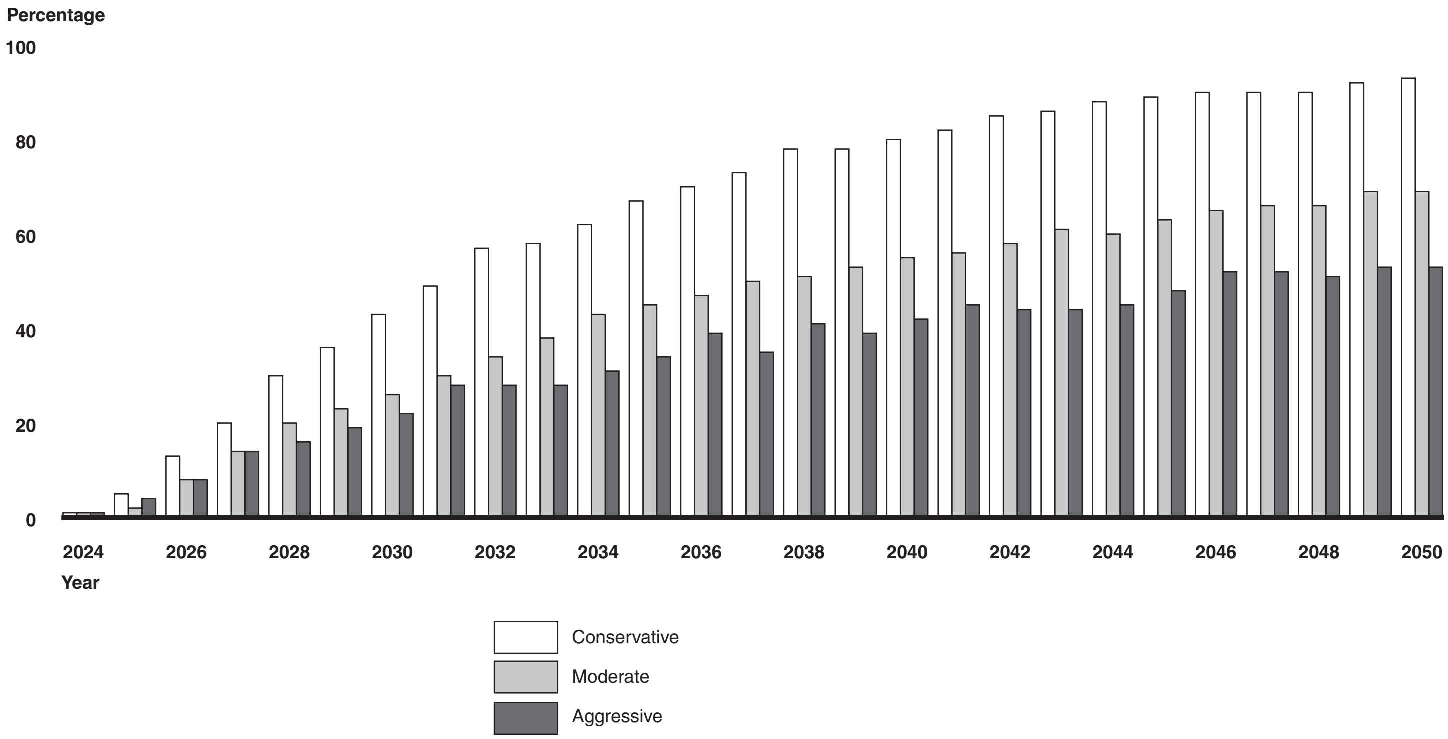
FSM Trust Fund Income

Under the conservative, moderate, and aggressive investment strategies that we projected, the FSM trust fund's annual income will probably not reach the maximum disbursement allowed, with the probability increasing with time. For example, our analysis shows more than 50 percent probability that the trust fund's income will not reach the maximum disbursement level allowed after 2031 under the conservative investment strategy, with the probability over 90 percent by 2050 (see fig. 7).

[33]The trust fund agreements specify that in 2024 and thereafter, the FSM and the RMI trust fund committees may disburse amounts up to the annual grant assistance in 2023, fully adjusted for inflation, provided that funds are available in the B account to reach such level. In 2025 and thereafter, the disbursements may also include any additional approved amounts for special needs.

[34]Our analysis shows that to maintain the maximum disbursement levels allowed for 10 years without risk, the FSM and the RMI trust funds need to earn compounded real returns of around 13 percent and 9 percent through 2023, respectively. However, these percentages are considerably higher than the stock market's compounded real returns from 1970 to 2005 of around 6 percent for both international stocks and U.S. large company stocks. If the trust funds are not in risk free treasury bonds and earn higher returns after 2023, the required returns for the funds before 2023 will be lower; however, the trust funds will be subject to market volatilities.

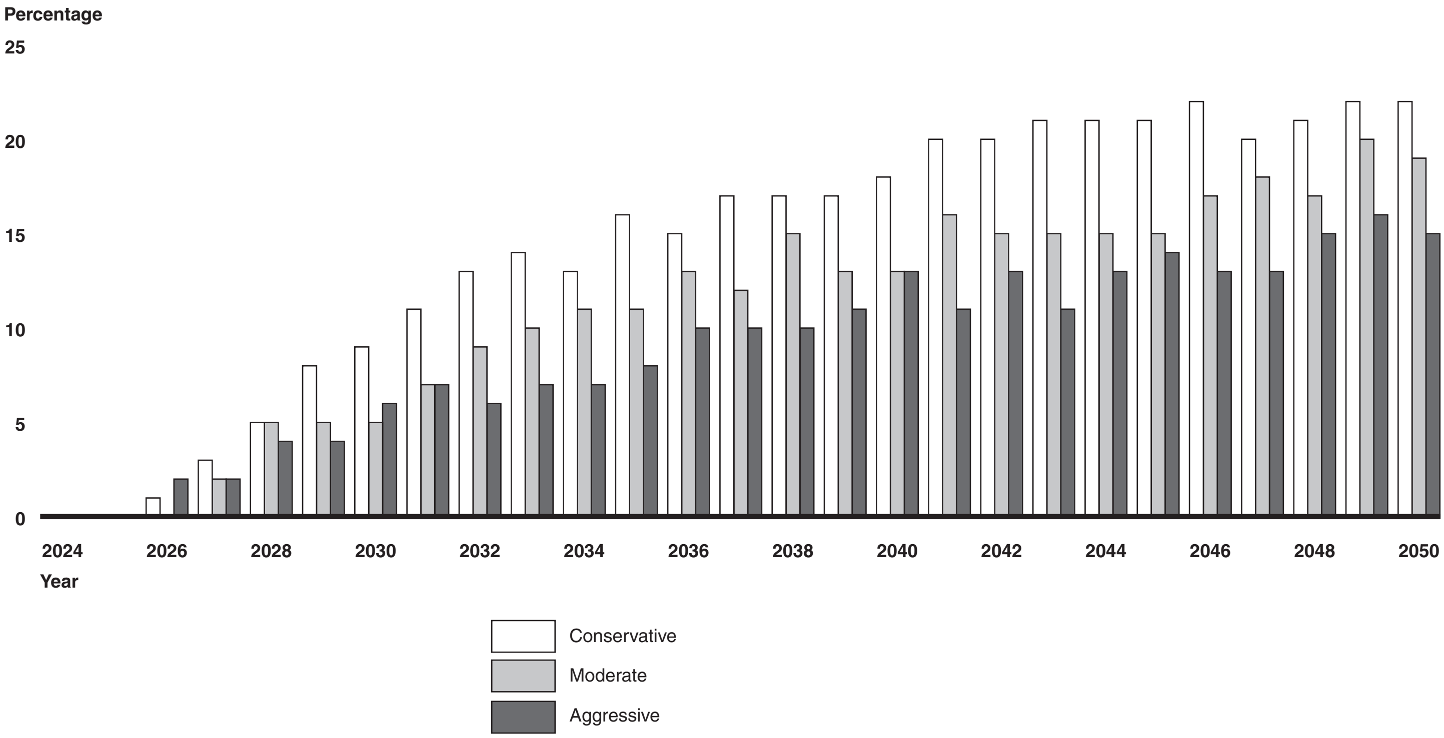
Figure 7: Probability of FSM Trust Fund Income Not Reaching the Maximum Disbursement Levels Allowed, Fiscal Years 2024 - 2050



Source: GAO.

Moreover, our analysis shows an increasing probability that market volatility could prevent the FSM trust fund from making any disbursements in some years, although a separate account—the C account—was set up to absorb some market volatility. As shows, under the conservative investment strategy, the probability of no disbursements grows from 0 percent in 2024 to over 20 percent in 2050 (see fig. 8).

Figure 8: Probability of No Disbursement from FSM Trust Fund, Fiscal Years 2024 - 2050



Source: GAO.

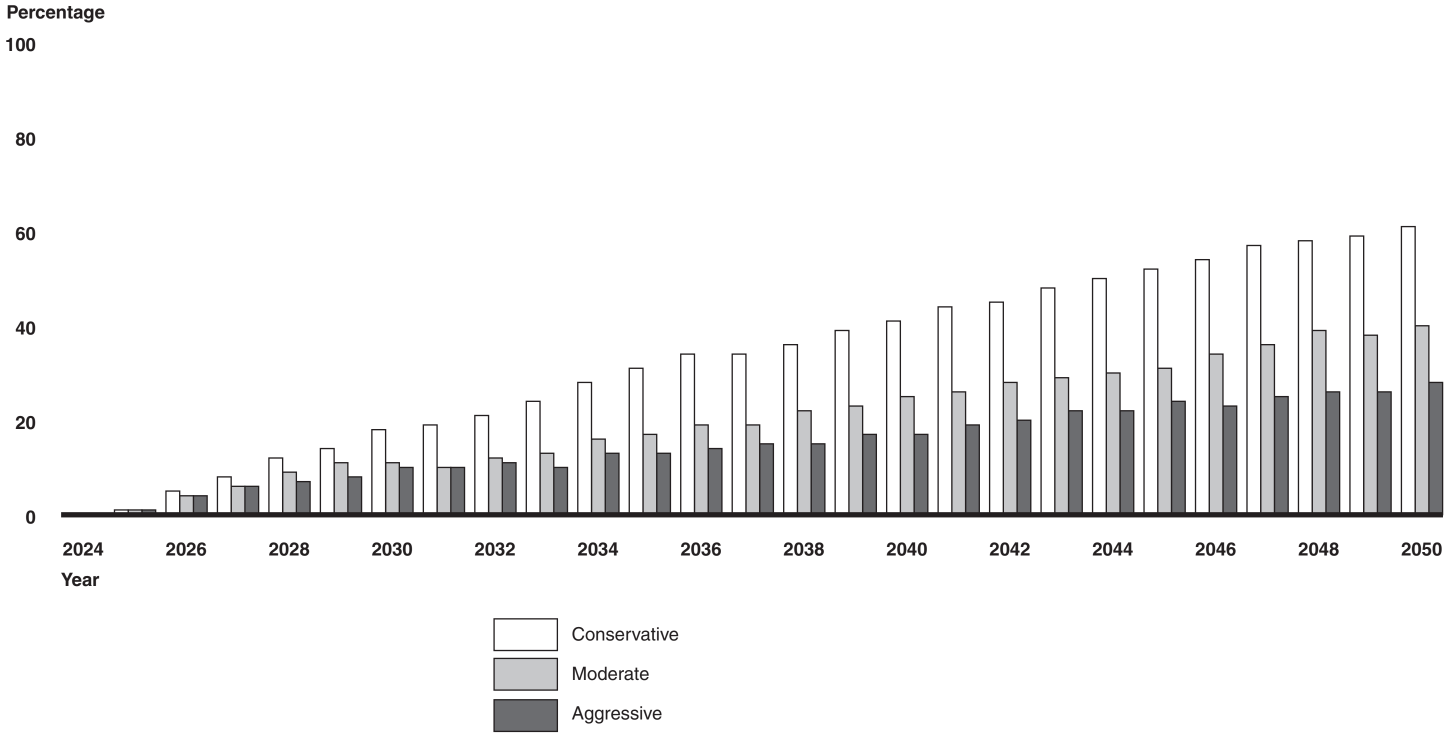
Note: The chart depicts results from 1,000 trial runs. The change from one year to the next may not always be monotonic, but the general time trend is clear. As the number of trial runs increase, the time trend becomes smoother.

Our analysis shows a wide range of probable disbursements from the FSM trust fund. For example, under the moderate investment strategy, 10 years after the trust fund starts to disburse income, we find a 57 percent probability that the trust fund will disburse the maximum level of income allowed, which is estimated at $97 million for 2034; a 11 percent probability that the trust fund will disburse no income; and a 33 percent probability that the trust fund will disburse some income, between $0 and $97 million.

RMI Trust Fund Income

Under the three potential investment strategies, income from the RMI trust fund is likely not to reach the maximum allowed disbursement, with the probability increasing over time. For example, our analysis shows a more than 20 percent probability that the trust fund's income will not reach the maximum allowed disbursement after 2031 under the conservative strategy, with the probability over 60 percent by 2050 (see fig. 9).

Figure 9: Probability of RMI Trust Fund Income Not Reaching the Maximum Disbursement Levels Allowed, Fiscal Years 2024 - 2050

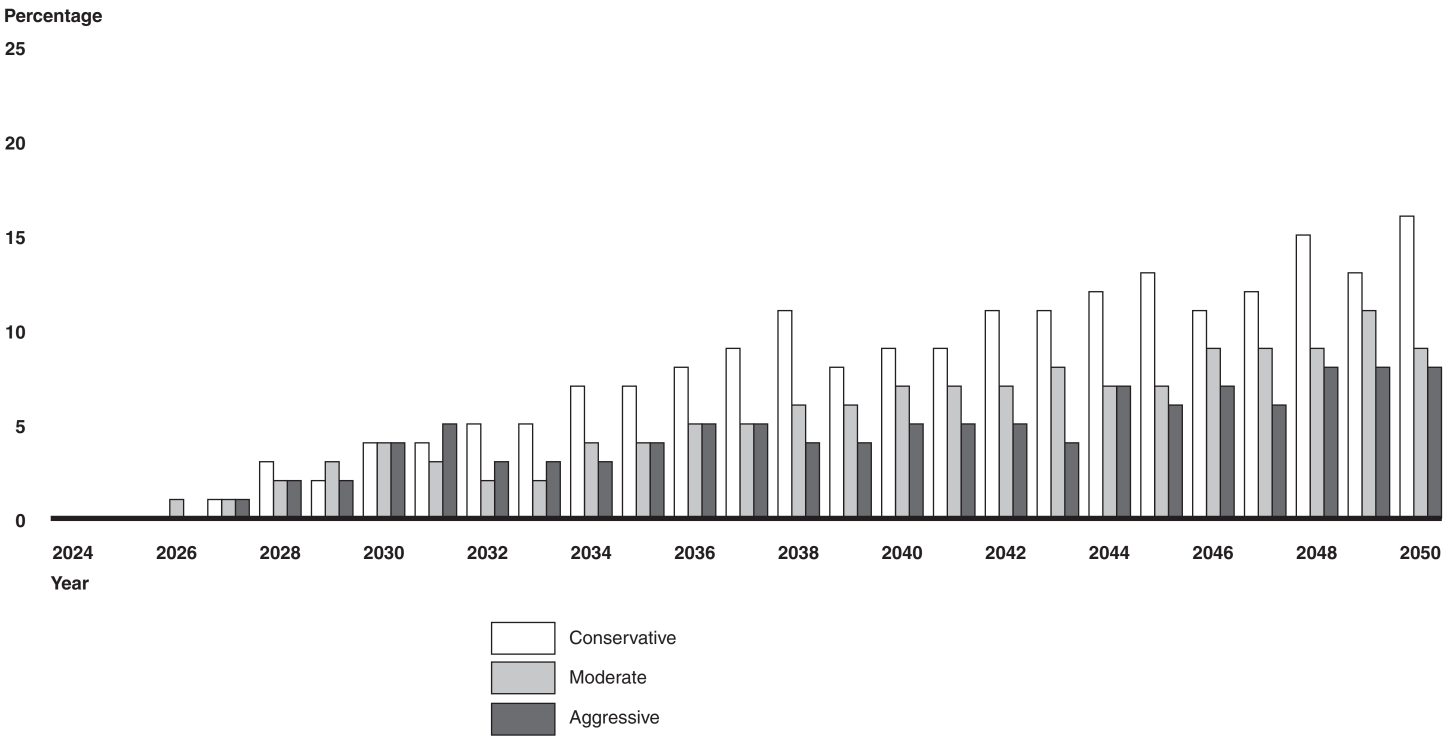


Source: GAO.

Note: This analysis includes Taiwan's contribution to the A account.

Additionally, our analysis shows an increasing probability that the RMI's trust fund could yield no disbursements in some years, despite the existence of the C account to absorb some market volatility. As figure 10 shows, under the conservative investment strategy, the probability of no disbursements rises from 0 percent in 2024 to more than 15 percent in 2050 (see fig. 10).

Figure 10: Probability of No Disbursement from RMI Trust Fund, Fiscal Years 2024 - 2050



Source: GAO.

Notes: This analysis includes Taiwan's contribution to the A account.

The chart depicts results from 1,000 trial runs. The change from one year to the next may not always be monotonic, but the general time trend is clear. As the number of trial runs increase, the time trend becomes smoother.

Our analysis shows a wide range of probable disbursements from the RMI trust fund. For example, under the moderate investment strategy, 10 years after the trust fund starts to disburse income, we find an 84 percent probability that the trust fund will disburse the maximum level of income allowed, which is estimated at $43 million for 2034; a 4 percent probability that the trust fund will disburse no income; and a 12 percent probability that the trust fund will disburse some income, between $0 and $43 million.

Several Options Exist for Supplementing FSM and RMI Trust Fund Income

The FSM and the RMI trust funds' income could be supplemented or enhanced by (1) greater tax revenue through economic development in the two countries, (2) increased remittances from growing numbers of emigrants, (3) economic assistance from other donors, and (4) securitization of the funds.[35] However, each possible scenario has limitations. In particular, although securitization could lead to higher trust fund balances in 2023, it also has the potential to lower investment income, reducing the balances.

Greater Tax Revenue through Economic Development

Economic development in the FSM and the RMI could increase the countries' tax revenue, helping to supplement the income from the trust funds. However, as we reported in 2006, the countries' development prospects remain limited—despite U.S. compact assistance since 1987, aimed at promoting economic advancement and budgetary self-reliance—and as a result, greater tax revenue may not be feasible.[36] Both countries' economies depend on public sector expenditure, funded largely by external assistance; in 2005, public sector expenditures—about two thirds of which were funded by grants—were about 60 percent of the gross domestic product. Further, both governments' budgets face growing wage expenditures, heightening the negative fiscal impacts they will face as compact grants decline. In both countries, the growth of key industries faces multiple constraints. Further, as we also reported in 2006, the FSM and the RMI have not undertaken many reforms needed for economic development.

Growing Emigration and Remittances

Growing emigration from the FSM and the RMI could help reduce the countries' reliance on the trust fund income: as the countries' populations decline, the governments' need for trust fund income to provide services would also decline. FSM and RMI residents can relocate to the United States relatively easily owing to rights granted under the original compact

[35]Through securitization, the trust fund sells bonds to investors, and the cash generated through bond issuance will become the trust fund principal to be invested. Future contributions to the trust fund will be used to pay bond holders before being available as income to the trust fund. Securitization helps build up the principal of the trust fund right away rather than slowly by annual contributions to the fund.

[36]GAO-06-590.

and extended by the amended compacts.[37] Many FSM and RMI citizens have chosen to exercise these rights: RMI data suggest that as of 2005, about 15,000 Marshallese had migrated to the United States, and FSM data suggest that almost twice as many Micronesians live overseas. In both countries, the likely effects of decreasing levels of per capita grant assistance may cause emigration to increase.

- *FSM.* If the FSM population maintains its 2004 level,[38] real per capita grant assistance in 2023, the last year of compact grants, will be about 73 percent of assistance in 2004, the first year of compact grants. Furthermore, even with the aggressive investment strategy we projected, the trust fund income is likely to be lower than the compact grant, continuing the declining trend in government resources. As a result, FSM living standards, including the availability of social services, will likely be reduced, potentially leading to further emigration.

- *RMI.* Per capita grant assistance in the last year of compact grants will be about 70 percent of assistance in the first year if the RMI population maintains its 2004 level. Given the aggressive investment strategy, per capita trust fund income in 2024 and thereafter may equal per capita grant assistance in 2023. However, if trust fund income is unreliable, as our analysis shows likely, RMI living standards, including the availability of social services, will probably be affected, possibly leading to increased emigration.

If increasing numbers of FSM and RMI residents choose to emigrate in the coming years as annual compact grants decrease, remittances from growing numbers of emigrants could supplement residents' income and, if taxed, could provide revenue to the FSM and the RMI governments. However, it is not certain that remittances would grow significantly or lead to increased government revenues. Although FSM and RMI emigrants could provide increasing monetary support to their home nations, inadequate education and vocational skills may limit their earning opportunities. As we reported in 2006, the 2003 U.S. census of FSM and RMI migrants in Hawaii, Guam, and the Commonwealth of the Northern

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[37]Under the original compacts, citizens from the FSM and the RMI had the right to live and work in the United States as "nonimmigrants" and to stay for long periods of time. Although the amended compacts strengthened immigration provisions, these rights were generally extended for citizens as defined under the amended compacts.

[38]Owing to emigration, growth of the FSM population has slowed from about 2 percent in the early 1990s to virtually zero since 1995.

Mariana Islands shows that almost half of them live below the poverty line. However, some economic experts emphasize that with an upgrading of skills, the FSM's and the RMI's free access and strong historical links to the U.S. economy create potential for the two nations to expand remittance income.[39]

Economic Assistance from Other Donors

Economic assistance, including contributions to the FSM and the RMI trust funds, from external sources other than the United States could lessen the countries' reliance on trust fund income. For example, our analysis shows that Taiwan's contribution of $40 million to the RMI's trust fund reduced by nearly 10 percent the probability that the trust fund not reaching the maximum disbursement level allowed in 2050. However, it is not certain whether the FSM trust fund will receive any such contributions or whether the RMI trust fund will receive any further contributions. Further, although both countries have previously received other economic assistance from donors besides the United States—for example, from the Asian Development Bank, Australia, and Japan—assistance in the future is not assured.

Trust Fund Securitization

Securitization of the trust funds—that is, issuing bonds against future U.S. contributions to the funds—has the potential to increase the funds' balances. The benefit from securitization would mainly derive from arbitrage, or potential differences in returns on investment and returns on the bonds issued to investors: the greater the differential, the greater the benefit from securitization.

However, although securitization of the trust funds carries potential benefits, our analysis shows that its introduction could subject the funds to greater risk. Because the full trust fund amounts would be invested after securitization, loss from securitization in the early years could lead to smaller investment income and trust fund balances in later years. Our analysis shows that securitization could result in a wider range of possible trust fund balances at the amended compacts' expiration (see table 4). For example, under the possible aggressive investment strategy, securitization

[39]Experts also suggest that in addition to increasing income from emigrant remittances, returning emigrants may bring back newly acquired skills and capital that could support growth in the home economy. See GAO-06-590; also see Francis X. Hezel, *Is That the Best You Can Do? A Tale of Two Micronesian Economies* (Honolulu: East-West Center, Pacific Islands Policy, 2006).

could result in an FSM trust fund balance of $579 million (10th percentile) to approximately $2.7 billion (90th percentile), with a median of $1.3 billion; without securitization, the trust fund balance could range from $664 million (10th percentile) to approximately $2.2 billion (90th percentile), with a median balance of about $1.2 billion.[40] Securitization could result in a similarly wider range of balances and larger median balance for the RMI trust fund.

Table 4: Projected Trust Fund Balances in 2023 with and without Securitization, under Aggressive Investment Strategy

Dollars in millions

	FSM		RMI	
Trust fund balance distribution statistics	**With securitization**	**Without securitization**	**With securitization**	**Without securitization**
10th percentile	$579	$664	$390	$438
Median	1,314	1,182	845	778
90th percentile	2,700	2,179	1,688	1,401
Standard deviation	912	647	590	422

Source: GAO.

According to officials of the FSM and the RMI trust fund committees, the committees are considering securitizing the funds but disagree over whether this option should be pursued. Some members believe that securitization could bring great financial benefits, as a company that performs securitization has asserted in presentations to the committees; other members are concerned about potential risks. Others raise concerns of whether the trust funds could pursue securitization under the current amended compacts and trust fund agreements or whether amendments to these agreements would be required. The committees have not initiated an independent analysis to assist in their decisions.

[40]Under different investment strategies, the range of possible fund balances will be different. However, securitization will still lead to a wider range of possible fund balances. Securitization can lead to a higher expected balance when the investment returns are higher than the rate the funds pay to its bond holders.

Conclusions

Since the enactment of the amended compacts with the FSM and the RMI, the trust fund committees have taken important steps to establish the funds. However, the committees' decision-making and administrative processes slowed the funds' establishment and investment, leading to lower potential investment earnings for the FSM. Until the committees develop strategies to improve these processes, their ability to take timely actions regarding the funds will likely be impeded. In addition, the committees' tardiness in publishing the required annual reports limited the public availability of information regarding the trust funds' establishment and the committees' oversight. Further, the reports do not assess the potential status of the funds as an ongoing source of revenue after the compact grants end. Given the likely effects of market volatility on the funds' investment earnings, such assessments are needed to help the countries develop other strategies for achieving the compact goals of economic advancement and long-term budgetary self reliance. Both countries have several options to supplement trust fund income after 2023, but these options have limitations and are not assured of success. Although the trust fund committees are considering one of these options—securitization—to increase the funds' balances, they have not yet initiated an independent analysis of securitization's potential benefits and risks, including the possibility that securitization could lead to lower trust fund balances in 2023.

Recommendations for Executive Action

To enhance the FSM and the RMI trust fund committees' oversight of the trust funds, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the committees, to work with other U.S. agencies on the committees to undertake the follow three actions:

- develop strategies to improve the timeliness of the committees' decision-making and administrative processes;
- ensure the committees' timely reporting of trust fund activities, including assessing the funds' likely status as a source of revenue and effectiveness in helping the countries achieve economic self-sufficiency and long-term budgetary self-reliance; and
- obtain a full and independent evaluation of the potential benefits and risks of using securitization to increase the trust fund balances.

Agency Comments and Our Evaluation

We received written comments from Interior, HHS, and State as well as from the FSM and RMI governments (see app. V through IX for detailed presentations of, and our responses to, these comments). We also received technical comments from State, which we incorporated in our report as appropriate. We did not receive any comment from Labor.

Interior, HHS, and the RMI government concurred with our first recommendation. Interior also generally concurred with our second recommendation. However, HHS and State stated that our report reflected a fundamental misunderstanding of the outcome of the negotiation of the amended compacts and a misreading of the international agreements, which we strongly disagree. Our report clearly stated that the purpose of the trust funds is to provide an ongoing source of revenue. To further clarify this point, we modified our recommendation and added language specifying that there is no minimum disbursement required or guaranteed by the trust fund agreements. We believe that careful analysis of the trust funds each year will help establish realistic expectations of the trust funds and provide information to the trust fund committees as they make investment decisions and to FSM and RMI government leaders as they set economic policies and undertake long-term fiscal planning. Interior, HHS, and the RMI government agreed with our third recommendation. The RMI noted that it would like the trust fund contributions to be fully adjusted for inflation. The FSM government in general agreed with all of our recommendations.

In addition to providing copies of this report to your offices, we will send copies to interested congressional committees. We will also provide copies of this report to the Secretaries of Health and Human Services, the Interior, Labor and State as well as the President of the Federated States of Micronesia and the President of the Republic of the Marshall Islands. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me at (202) 512-3149 or gootnickd@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix X.

David Gootnick
Director, International Affairs and Trade

List of Congressional Committees

The Honorable Jeff Bingaman
Chairman
The Honorable Pete V. Domenici
Ranking Member
Committee on Energy and Natural Resources
United States Senate

The Honorable Joseph R. Biden, Jr.
Chairman
The Honorable Richard G. Lugar
Ranking Member
Committee on Foreign Relations
United States Senate

The Honorable Nick J. Rahall, II
Chairman
The Honorable Don Young
Ranking Member
Committee on Natural Resources
House of Representatives

The Honorable Tom Lantos
Chairman
The Honorable Ileana Ros-Lehtinen
Ranking Member
Committee on Foreign Affairs
House of Representatives

Appendix I: Objectives, Scope, and Methodology

In this report on the trust funds established under the U.S. government's amended compacts with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI), we examine (1) the trust fund committees' progress in establishing, investing, and reporting on the funds; (2) the sustainability of income from the trust funds after the compact grants end in 2023; and (3) other potential sources of revenue to supplement or enhance trust fund income after 2023.

To review the trust fund committees' progress in establishing, investing, and reporting on the funds, we reviewed the amended compacts, trust fund agreements; annual trust fund reports for 2004 and 2005 by the trust fund committee, trust fund bank statements, and documents related to the request for proposals to set up the trust funds. We interviewed officials from the Departments of the Interior, Health and Human Services, Labor, and State. We also interviewed relevant RMI and FSM officials and representatives from companies involved in setting up, investing, and managing the trust funds.

To project the trust fund income level after the U.S. annual compact grants end, we obtained historical returns of various asset classes, including large company stocks, international stocks, and U.S. treasury bills, from 1970 to 2005 and built a projection model based on the historical returns, contributions to the trust fund, and rules governing the disbursement from the trust fund as outlined in the trust fund agreements. We used the inflation projection by the Congressional Budget Office to adjust the contribution and grant levels (see app. II for a detailed discussion on the key inputs to the projection model). We used a solver function in our projection model to find the minimum level of return between 2007 and 2023 required, so that the trust fund income equals the 2023 grant level plus full inflation for at least the first 10 years after trust fund disbursements begin. For this calculation, we assumed the trust funds will be put into U.S. treasury bonds after 2023. To assess the impact of market volatility on the trust fund income, we used the Monte Carlo simulation with computer-generated random draws from a predefined distribution, based on the historical returns and volatilities of the various asset classes. Each random draw produces a possible outcome of the variables we are interested in, such as the balance of the trust fund and the level of disbursement in a particular year; 1,000 random draws generates 1,000 possible outcomes. We studied the distribution of the outcomes to determine, for instance, the probability that the trust funds' annual disbursements will be below the maximum allowed disbursement levels. Probabilistic projection of the trust funds' income is an improvement over the methodology based on constant returns because investment returns are volatile.

To examine other potential sources of revenue to supplement the trust fund income, we reviewed studies on the economic conditions in the FSM and the RMI. We also reviewed studies examining emigration of the FSM and RMI citizens. To examine the potential benefit and risks of securitization, we modified the simulation model and compared the trust funds' balance in 2023 with and without securitization. We assumed the bond issued by the trust fund pays an annual return of 5.5 percent.[1]

To ensure the soundness of our projection, we obtained and incorporated technical comments on the simulation assumptions and methodology from Interior and the investment adviser of the FSM trust fund.

We conducted our review from July 2006 to March 2007 in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the Departments of the Interior, Health and Human Services, and State as well as the governments of the FSM and the RMI. All of these entities' comments are discussed in the report and are reprinted in appendix V through IX. In addition, we considered all technical comments and made changes to the report, as appropriate.

[1]This number is based on our conversation with an industry expert.

Appendix II: Technical Notes on the Trust Fund Simulation Model

The key inputs that we used to simulate the trust fund income after 2023 include (1) the trust funds' balances at the beginning of the projection, (2) contributions to the trust funds, (3) inflation adjustment to the contributions, (4) different accounts of the trust funds and the rules governing the inter-account transfers, (5) the simulation equation; (6) distribution of returns for the Monte Carlo simulation, and (7) Monte Carlo simulation results.

1. *Trust fund balance at the beginning of the projection*

As of September 30, 2006, the FSM trust fund had a balance of $86.53 million and the RMI trust fund had a balance of $63.14 million.

2. *Contributions to the trust fund*

Table 5 shows scheduled contributions to the FSM and the RMI trust funds by the United States, as outlined in the amended compacts. Table 5 shows scheduled contributions to the RMI trust fund by Taiwan, as outlined in its agreement with the RMI.

Table 5: U.S. Scheduled Contributions to FSM and RMI Trust Funds, as Outlined in Amended Compacts

Dollars in millions

	U.S. contribution	
Fiscal year	**FSM trust fund**	**RMI trust fund**
2004	$16	$7
2005	16	7.5
2006	16	8
2007	16.8	8.5
2008	17.6	9
2009	18.4	9.5
2010	19.2	10
2011	20	10.5
2012	20.8	11
2013	21.6	11.5
2014	22.4	12
2015	23.2	12.5
2016	24	13
2017	24.8	13.5
2018	25.6	14

Dollars in millions

	U.S. contribution	
Fiscal year	FSM trust fund	RMI trust fund
2019	26.4	14.5
2020	27.2	15
2021	28	15.5
2022	28.8	16
2023	29.6	16.5

Source: Public Law 108-188.

Table 6: Taiwan's Scheduled Contributions to RMI Trust Fund, as Outlined in Agreement with RMI Government

Dollar in millions

Fiscal year	Contribution to A account	Contribution to D account
2004	$1.00	$3.00
2005	0.75	1.75
2006	0.75	1.75
2007	0.75	1.75
2008	0.75	1.75
2009	2.40	0.00
2010	2.40	0.00
2011	2.40	0.00
2012	2.40	0.00
2013	2.40	0.00
2014	2.40	0.00
2015	2.40	0.00
2016	2.40	0.00
2017	2.40	0.00
2018	2.40	0.00
2019	2.40	0.00
2020	2.40	0.00
2021	2.40	0.00
2022	2.40	0.00
2023	2.40	0.00

Source: Subsequent Contributor Accession Agreement between The Trust Fund Committee Established by the Government of the United States of America, and the Government of the Republic of the Marshall Islands Implementing Section 216 and Section 217 of the Compact, as Amended and Taiwan.

Note: Our projection included Taiwan's contribution to the A account, but not the D account because it is a separate account from the rest of the trust fund.

3. Inflation adjustment

The compact grants and the U.S. trust fund contributions are adjusted for inflation by a percentage that equals the lesser, in any year, of two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator or 5 percent, using the beginning of 2004 as a base. Both grant funding and trust fund contributions can be fully adjusted for inflation after 2014 under certain U.S. inflation conditions.

4. Trust fund accounts and transfer rules

The trust fund agreements allow for several types of transfers among the A, B, and C accounts that we used in our projections.

Before 2023:

- *From A to C.* At the end of each year before disbursement starts in 2024, income exceeding 6 percent of the corpus shall be deposited in the C account. The C account cannot exceed three times the estimated equivalent of the fiscal year 2023 grant level, adjusted for inflation.

- *From C to A.* Any amount in the C account exceeding three times the estimated equivalent of the fiscal year 2023 grant level, adjusted for inflation, shall return to the A account.

Beginning in 2023:

- *From A to B.* During 2023 and each subsequent year, all investment income will be transferred from the A account to the B account for possible disbursement in the following year.

- *From B to A or C.* If the B account balance exceeds the annual grant assistance level in 2023 plus full inflation, the excess will be transferred to the A account. However, if the C account falls short of the specified level (three times the estimated equivalent of the 2023 grant level, inflation adjusted), any excess in the B account will be transferred to the C account to make up the shortfall.

- *From C to disbursement or A account.* If the B account falls short of the previous year's disbursement, inflation adjusted, the C account can be drawn on to cover the shortfall. (The trust fund corpus may not be accessed for this purpose.) Any amount in the C account exceeding three times the estimated equivalent of the fiscal year 2023 grant level, adjusted for inflation, shall return to the A account.

In our projection, we assume that the trust funds will disburse the maximum allowed amount if it is available. However, the trust fund committees may disburse less than the maximum amount allowed and reinvest some income. For a discussion of how partial disbursement can affect the probability of trust fund income not reaching the maximum disbursement level allowed (see app. III).

5. *Simulation equation*

For the Monte Carlo simulation of trust fund balances, we used the equation $W_{t+1} = (W_t + C_t - AW_t) * (1+r_t) * (1-F_t)$, where

W_{t+1} = value of the fund at the beginning of year t+1

W_t = value of the fund at the beginning of year t

C_t = contribution to the fund at the beginning of year t

r_t = the annual return in year t

AW_t = the annual withdrawal in year t

F_t = the fees as a percentage of account value the trust fund pays to its trustee, investment adviser, money managers, and lawyers, etc. (We assume the fees to be 1 percent of the account value.)

6. *Distribution of returns for Monte Carlo simulation*

The returns on the trust fund will be randomly drawn from a custom distribution, which is based on historical real returns of the various asset classes and the proportion of the asset in the investment strategy. The distributions for international stocks, large company stocks, and U.S. treasury bills are illustrated in table 7.

Table 7: Real Returns Distribution Based on Historical Data from 1970 to 2005

International stocks			Large company stocks			U.S. treasury bills		
Range		Probability	Range		Probability	Range		Probability
-30.61%	-27.61%	2.86%	-34.47%	-23.91%	2.86%	-3.74%	-2.59%	2.86%
-27.61	-22.41	2.86	-23.91	-21.56	2.86	-2.59	-1.99	2.86
-22.41	-21.11	2.86	-21.56	-13.23	2.86	-1.99	-1.72	2.86
-21.11	-17.62	2.86	-13.23	-13.07	2.86	-1.72	-1.70	2.86
-17.62	-16.78	2.86	-13.07	-12.71	2.86	-1.70	-1.55	2.86
-16.78	-15.17	2.86	-12.71	-12.09	2.86	-1.55	-1.13	2.86
-15.17	-14.33	2.86	-12.09	-8.75	2.86	-1.13	-1.03	2.86
-14.33	-9.15	2.86	-8.75	-2.27	2.86	-1.03	-0.84	2.86
-9.15	-6.29	2.86	-2.27	-1.40	2.86	-0.84	-0.71	2.86
-6.29	-4.55	2.86	-1.40	-1.32	2.86	-0.71	-0.43	2.86
-4.55	-1.02	2.86	-1.32	0.79	2.86	-0.43	0.15	2.86
-1.02	0.35	2.86	0.79	1.44	2.86	0.15	0.26	2.86
0.35	2.94	2.86	1.44	2.23	2.86	0.26	0.42	2.86
2.94	3.76	2.86	2.23	4.53	2.86	0.42	0.59	2.86
3.76	5.25	2.86	4.53	4.64	2.86	0.59	0.98	2.86
5.25	5.88	2.86	4.64	7.05	2.86	0.98	1.00	2.86
5.88	8.79	2.86	7.05	7.37	2.86	1.00	1.02	2.86
8.79	9.15	2.86	7.37	10.59	2.86	1.02	1.20	2.86
9.15	10.25	2.86	10.59	11.87	2.86	1.20	1.60	2.86
10.25	10.70	2.86	11.87	15.06	2.86	1.60	1.83	2.86
10.70	11.85	2.86	15.06	16.89	2.86	1.83	1.85	2.86
11.85	16.89	2.86	16.89	17.15	2.86	1.85	1.95	2.86
16.89	18.42	2.86	17.15	17.81	2.86	1.95	2.25	2.86
18.42	19.65	2.86	17.81	17.88	2.86	2.25	2.42	2.86
19.65	20.05	2.86	17.88	18.03	2.86	2.42	2.46	2.86
20.05	23.15	2.86	18.03	18.16	2.86	2.46	2.98	2.86
23.15	23.18	2.86	18.16	19.12	2.86	2.98	3.20	2.86
23.18	23.98	2.86	19.12	25.65	2.86	3.20	3.50	2.86
23.98	26.94	2.86	25.65	26.33	2.86	3.50	3.55	2.86
26.94	28.12	2.86	26.33	26.54	2.86	3.55	3.81	2.86
28.12	29.38	2.86	26.54	26.67	2.86	3.81	4.82	2.86
29.38	33.06	2.86	26.67	27.36	2.86	4.82	4.97	2.86
33.06	36.60	2.86	27.36	28.21	2.86	4.97	5.30	2.86
36.60	51.03	2.86	28.21	31.13	2.86	5.30	5.68	2.86

International stocks			Large company stocks			U.S. treasury bills		
Range		Probability	Range		Probability	Range		Probability
51.03	68.04	2.86	31.13	34.03	2.86	5.68	6.42	2.86

Source: GAO.

Cross-correlation and serial correlation are built into the Monte Carlo random draws to capture the co-movement of the asset classes and over time. (See table 8.)

Table 8: Cross-Correlation and Serial Correlation of Historical Annual Returns

	International	Large company	U.S. treasury bills
International	1		
Large company	0.59	1	
Treasury bills	-0.12	0.05	1
Serial correlation	0.15	0.04	0.81

Source: GAO.

7. *Monte Carlo simulation results*

Each year's return is randomly selected from the return distribution of each asset class. The simulation is run 1,000 times, yielding 1,000 possible outcomes and providing a distribution of annual investment income, account balance, and disbursements. (Table 9 and table 10 show the first 20 trial values from the simulation of the FSM and RMI trust fund account balance.)

Table 9: First 20 of the 1,000 Trial Values of the FSM Trust Fund Balances under Moderate Investment Strategy, Fiscal Years 2006-2023

Dollars in millions

Trial values	2006	2007	2008	2009	2010	2011	2012	2013
1	$86.5	$133.3	$170.7	$192.8	$196.5	$167.5	$198.7	$236.5
2	86.5	107.5	154.0	194.2	251.4	328.3	332.6	323.1
3	86.5	93.51	138.4	176.0	230.4	267.3	290.0	312.7
4	86.5	129.6	181.4	188.3	210.6	202.1	250.6	295.4
5	86.5	121.5	134.4	148.5	182.6	275.5	386.8	474.9
6	86.5	128.8	124.2	124.4	151.0	155.3	216.6	253.4
7	86.5	122.6	140.2	192.4	202.7	225.3	327.1	358.3
8	86.5	109.1	112.7	174.9	250.4	247.4	256.1	346.3
9	86.5	103.5	140.3	174.8	205.3	256.2	269.1	333.7
10	86.5	99.03	136.1	141.6	173.8	223.9	276.3	337.7
11	86.5	109.5	180.9	214.1	248.7	228.9	330.3	368.2
12	86.5	97.02	129.3	167.2	233.5	274.1	365.2	433.8
13	86.5	91.73	112.9	157.1	204.7	253.1	327.4	388.0
14	86.5	92.69	137.1	147.5	208.1	200.7	256.6	296.7
15	86.5	99.15	107.0	114.7	139.2	207.4	265.7	359.9
16	86.5	98.08	134.3	164.1	160.8	192.9	241.0	347.1
17	86.5	108.0	147.3	195.2	246.9	358.8	464.1	461.7
18	86.5	122.4	150.2	187.1	226.1	346.9	413.8	371.4
19	86.5	116.2	138.9	202.0	218.2	268.0	300.9	270.6
20	86.5	147.8	222.5	293.7	304.0	376.2	362.8	399.9
10th percentile	86.5	94.23	112.2	135.2	157.6	182.2	210.6	236.9
median	86.5	111.6	139.2	171.5	206.3	244.1	288.9	331
90th percentile	86.5	128.3	169.3	213.8	261.4	323.8	387	455.5

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
$262.6	$291.6	$301.1	$288.9	$299.4	$282.1	$318.14	$349.58	$409.71	$545.09
337.4	331.8	431.0	497.9	497.0	501.3	520.58	597.5	697.86	907.24
426.2	496.6	522.3	517.4	695.7	842.4	724.48	807.41	1,150.4	1,223.6
402.8	552.2	719.4	937.4	1,000.8	1,029.0	1,267.4	1,357.3	1,771.1	1708
598.9	688.9	932.0	980.7	937.1	1,056.0	1,203.1	1,326.2	1,420.6	1,660.3
349.2	412.0	471.1	569.9	606.2	614.3	768.84	926.91	907.27	932.03
402.5	539.4	679.3	722.9	860.3	1,182.9	1,153.4	1,243.7	1,180.5	1212.3
308.2	314.7	419.3	485.5	540.9	553.9	606.9	772.66	728.88	895.66
447.0	513.0	523.3	619.4	614.1	692.9	758.54	811.66	808.01	943.09
495.8	606.1	621.7	858.4	848.1	925.2	1,137.5	1,022.2	1,182.5	1507.2
392.6	543.5	710.9	782	711.2	783.0	860.09	769.16	651.13	782.25
472.3	436.6	484.6	541.4	530.7	655.9	705.5	806.55	1,164.4	1057.9
503.8	432.6	504.2	581	535.0	687.2	772.5	987.18	1,038.2	1353.6
382.2	443.1	471.2	600.2	764.5	819.6	803.22	925.79	865.13	959.52
456.8	523.4	579.3	560.2	616.3	776.9	1003	1,112.8	1,211.2	1177.6
417.3	449.1	424.7	398.9	361.4	484.6	593.15	689.94	817.63	858.45
471.0	546.3	621.2	704	907.6	1,083.6	888.67	1,021.2	1,308.6	1,589.2
489.0	519.9	677.1	752.7	901.5	1,151.8	1,072.1	1,535.1	1,668.8	1,970.0
291.6	333.6	435.3	526.8	567.9	716.84	889.64	1,169.8	1,402.7	1,489.3
569.8	752.8	931.8	1,149.0	1,467.0	1,466.6	1,727.6	2,193.6	2,290.8	2,525.2
269.1	305.4	342.6	389.3	437.95	473.23	530.46	592.95	651.05	709.73
379.3	433.7	501.8	563.4	643.53	717.1	798.43	910.03	1018.1	1107.9
531.5	623.3	717.3	824.9	940.75	1079.6	1205.9	1351.4	1513.2	1723.9

Source: GAO.

Table 10: First 20 of the 1,000 Trial Values of the RMI Trust Fund Balance under Moderate Investment Strategy, Fiscal Years 2006-2023

Dollars in millions

Trial values	2006	2007	2008	2009	2010	2011	2012	2013
1	$63.1	$83.4	$101.8	$143.4	$153.2	$191.4	$214.8	$280.8
2	63.1	91.8	123.5	134.3	178.3	201.3	253.5	327.6
3	63.1	73.4	93.8	114.0	159.7	190.5	194.0	242.6
4	63.1	78.0	78.5	102.0	114.0	144.3	126.4	125.9
5	63.1	77.9	89.0	106.7	131.3	178.0	211.1	261.9
6	63.1	79.5	96.9	98.0	100.0	120.5	128.1	157.6
7	63.1	77.9	118.9	131.5	125.8	160.8	214.1	243.7
8	63.1	69.5	93.7	119.8	134.1	175.2	205.5	231.0
9	63.1	73.7	96.9	126.2	147.7	179.7	196.2	216.4
10	63.1	63.4	80.0	103.8	113.0	140.9	151.4	193.0
11	63.1	75.7	86.6	136.6	163.2	172.0	204.4	237.7
12	63.1	84.7	106.7	146.8	197.8	251.4	232.1	289.0
13	63.1	80.0	98.7	110.2	111.1	140.1	207.6	220.5
14	63.1	69.0	82.1	78.4	74.6	86.8	102.5	134.0
15	63.1	66.1	87.3	78.4	93.0	99.7	98.3	116.4
16	63.1	73.3	96.7	96.8	132.5	132.5	123.1	116.1
17	63.1	75.7	90.1	114.7	115.6	155.0	204.3	268.1
18	63.1	59.1	63.2	71.1	93.5	111.4	146.6	139.7
19	63.1	90.7	110.1	119.9	160.1	167.6	242.4	301.3
20	63.1	77.8	93.2	120.6	147.2	221.6	287.5	330.3
10th percentile	63.1	65.5	76.7	89.1	103.7	119.7	137.6	156.3
median	63.1	78.5	95.5	114.9	137.3	161.6	185.5	214.3
90th percentile	63.1	89.4	114.7	145.7	177.1	212.8	252.6	299.7

2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
$335.2	$369.3	$354.1	$401.7	$501.7	$568.5	$651.7	$604.2	$607.6	$579.2
456.9	632.5	688.6	919.0	1,034.5	1,054.9	1,209.7	1,123.2	1,043.1	1102.8
232.4	232.5	282.0	283.3	357.4	420.5	511.7	596.8	585.8	548.2
156.1	145.7	213.3	278.4	283.4	366.5	340.7	314.0	345.2	819.4
295.3	321.9	383.0	434.9	477.3	567.8	625.5	649.9	727.3	565.8
196.6	169.7	175.4	250.3	323.5	401.3	370.2	469.6	508.9	979.4
227.1	286.1	320.2	389.6	389.3	434.6	426.6	499.5	601.1	1,080.5
315.0	375.9	433.4	504.2	564.2	617.8	528.1	683.9	752.1	786.8
282.5	325.2	378.0	403.0	426.9	464.8	469.6	465.6	555.9	647.2
252.5	317.3	278.8	344.6	429.7	469.7	455.9	570.9	732.0	1,436.0
213.0	271.5	275.0	360.5	344.3	479.8	648.8	746.2	814.2	494.1
351.3	314.2	313.6	355.0	386.6	436.3	626.0	659.0	785.0	582.3
252.1	322.8	337.7	386.8	343.2	332.6	373.1	387.2	417.3	662.6
150.9	170.7	216.6	287.2	342.5	380.5	447.7	479.6	489.5	701.3
118.6	158.1	164.0	185.0	175.8	240.3	272.7	343.2	415.4	841.7
170.9	215.8	270.7	354.6	451.1	471.3	471.3	554.4	506.4	602.2
263.9	343.5	418.3	445.8	547.0	685.5	812.2	831.6	843.2	751.8
149.1	204.0	266.5	282.8	242.7	307.0	302.8	410.9	496.1	936.0
274.8	290.9	366.2	365.8	496.8	538.5	588.7	518.9	510.3	437.1
360.1	397.7	335.6	432.7	404.9	398.8	409.4	468.7	532.8	521.0
176.9	197.7	218.9	246.9	272.0	299.8	337.3	367.8	400.4	439.2
247.1	280.5	315.2	357.7	402.3	451.1	495.4	556.3	611.9	676.5
345.3	397.6	456.9	522.4	597.4	654.4	743.1	831.6	919.5	1,103.0

Source: GAO.

Appendix III: Disbursing All Income Compared to Disbursing Partial Income

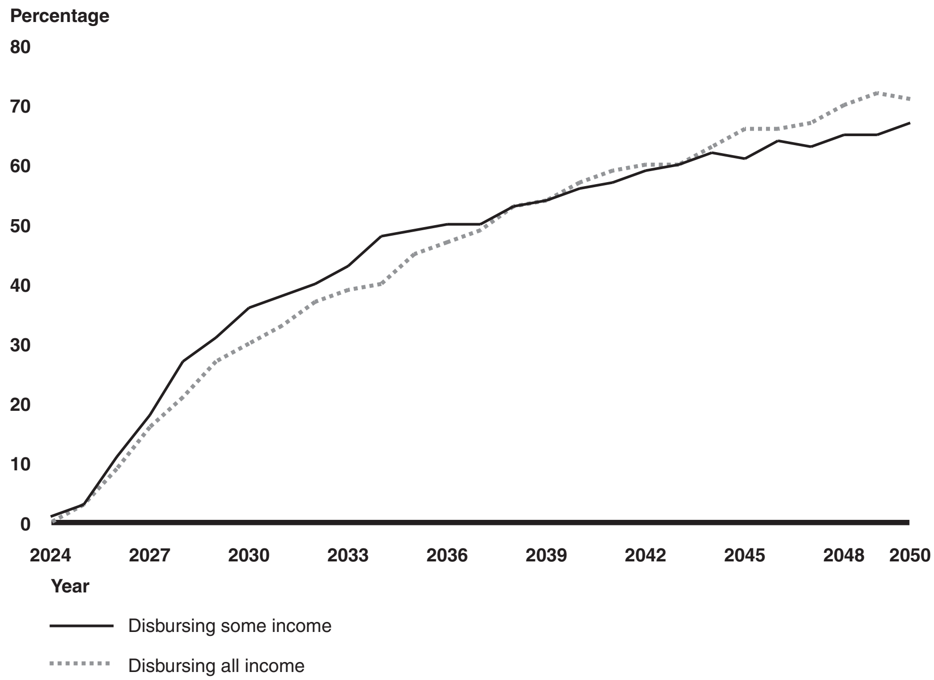
The U.S. trust fund agreements with the FSM and the RMI state that the trust fund committees may disburse an amount up to the inflation-adjusted grant assistance in fiscal year 2023. However, if the trust fund committees disburse less than the maximum allowed levels and reinvest part of the trust fund income, this will change the probability that the funds' income will not reach the maximum allowed disbursement levels.[1]

Figures 11 and 12, respectively, compare the probabilities, under our projected moderate investment strategy, of the FSM and the RMI trust fund income's not reaching the maximum disbursement level allowed when all income is disbursed versus when partial income is disbursed[2] During the earlier years, the probability that income will not reach the maximum disbursement level allowed is generally greater when only partial income is disbursed. However, the probability that income will not reach the maximum disbursement level allowed is lower in later years, because the benefit of the reinvested trust fund income helps protect the trust fund principal against inflation.

[1]According to 2005 study by the Asian Development Bank, a trust fund established with similar objectives for another Pacific island country, Tuvalu, reinvests trust fund income to maintain the fund's real value. The Tuvalu trust fund was established through a multilateral international agreement among Tuvalu, New Zealand, the United Kingdom, and Australia. See Benjamin Graham, *Trust Funds in the Pacific, Their Roles and Future* Manila, Philippines: Asian Development, 2005.

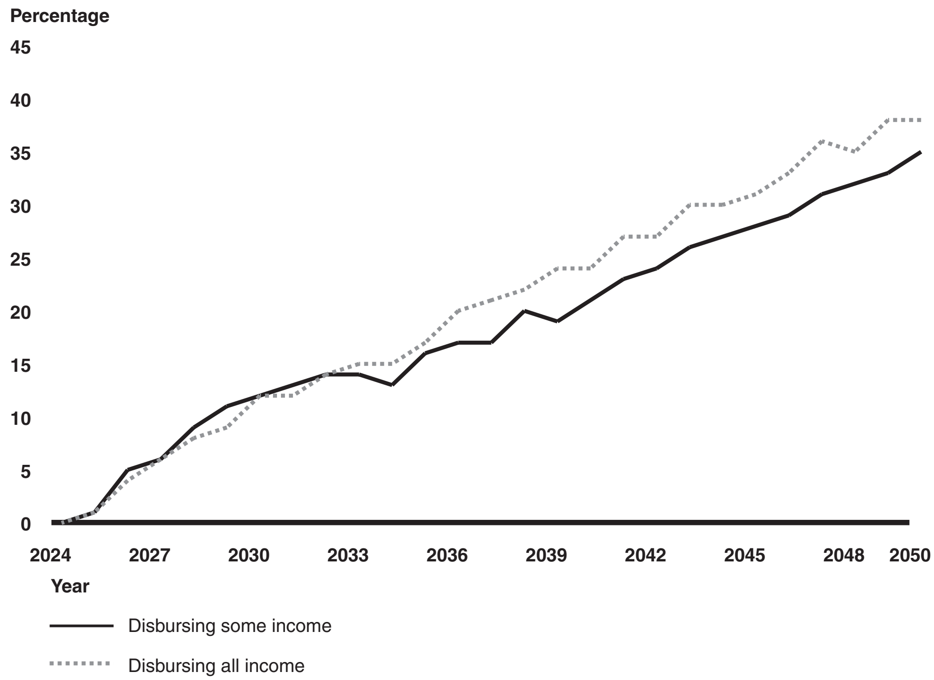
[2]There are many different ways to disburse investment income partially. For example, the trust fund can disburse only income above inflation; the trust fund can reinvest to keep the corpus at a certain level before it starts to disburse any income. In this analysis, partial disbursement means disbursing income above inflation.

Figure 11: Probabilities That FSM Trust Fund Income Will Not Reach the Maximum Disbursement Level Allowed When Disbursing All Income vs. Disbursing Partial Income



Source: GAO.

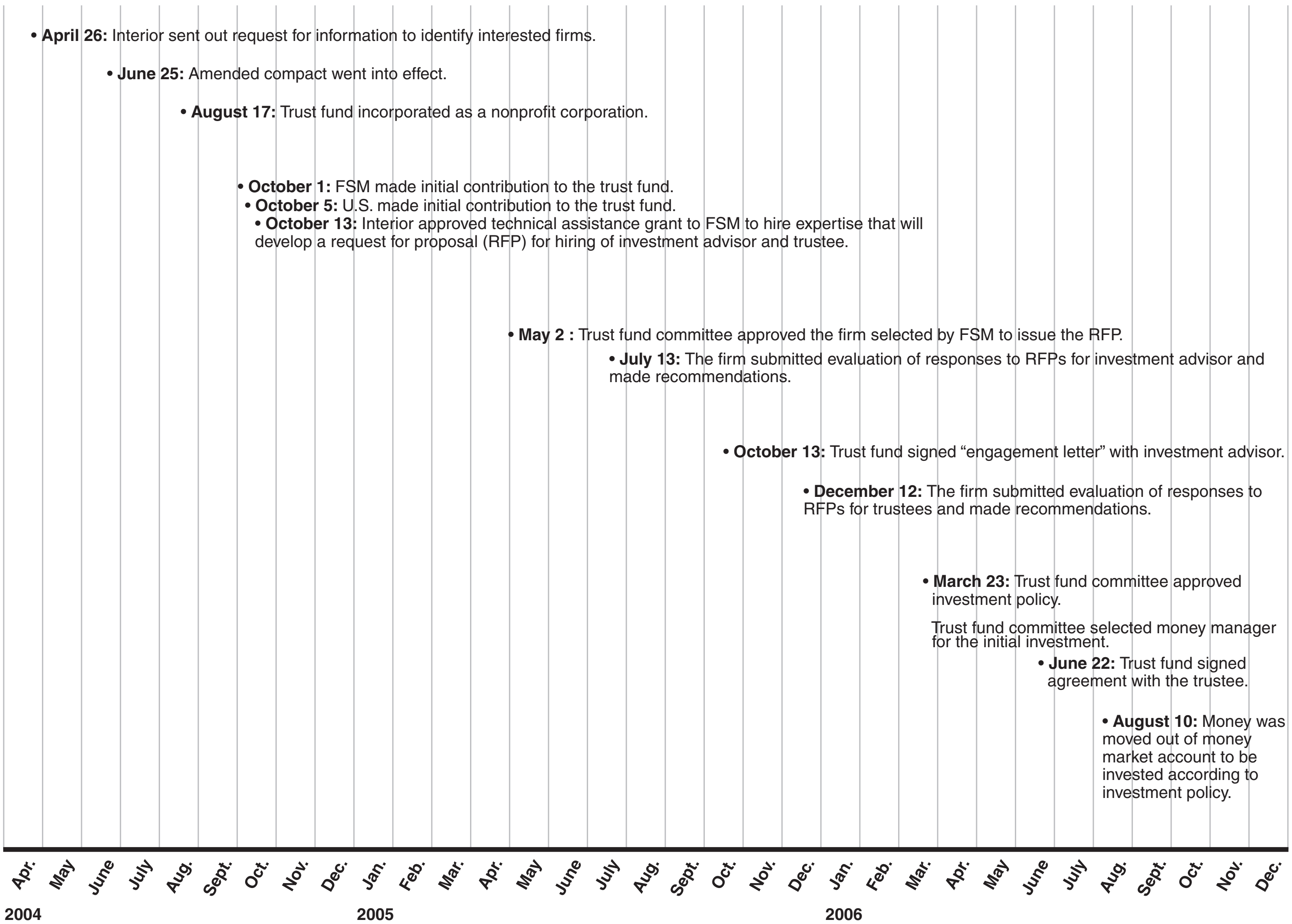
Figure 12: Probabilities That RMI Trust Fund Income Will Not Reach the Maximum Disbursement Level Allowed When Disbursing All Income vs. Disbursing Partial Income



Source: GAO.

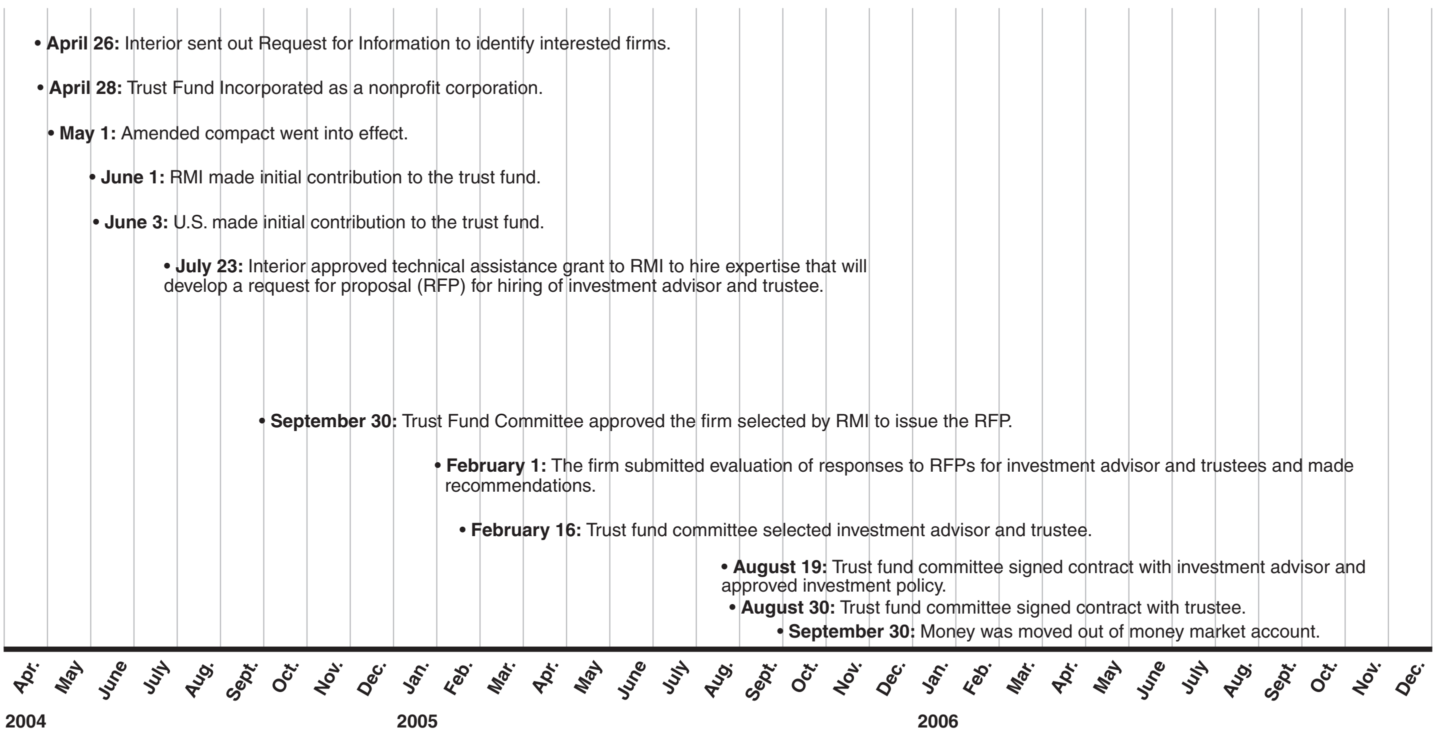
Appendix IV: Key Events in the Establishment of the FSM and RMI Trust Funds

Figure 13: Key Events in the Establishment of the FSM Trust Fund



Source: GAO.

Figure 14: Key Events in the Establishment of the RMI Trust Fund



Source: GAO.

Note: The years shown are calendar years (Jan. 1 – Dec. 31).

Appendix V: Comments from the Department of the Interior

Note: GAO comment supplementing those in the report text appears at the end of this appendix.

THE ASSOCIATE DEPUTY SECRETARY OF THE INTERIOR
WASHINGTON, DC 20240

MAY 11 2007

Mr. David Gootnik
Director
International Affairs and Trade
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Gootnik:

Thank you for the opportunity to review and comment on the Government Accountability Office Draft Report no. GAO-07-513, entitled *Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income*. The Department of the Interior finds the Draft Report to be a thoughtful and useful analysis and generally agrees with the recommendations made by GAO.

The enclosure describes the specific actions that will be taken by the Chairman of the Trust Fund Committees to address the three recommendations of the Draft Report. If you have any questions, please communicate with David B. Cohen, Deputy Assistant Secretary of the Interior for Insular Affairs, or Nikolao Pula, Director of the Office of Insular Affairs, at (202) 208-4736.

Sincerely,

James E. Cason

James E. Cason

Enclosure

Enclosure

U.S. Government Accountability Office Draft Report
COMPACTS OF FREE ASSOCIATION: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income
GAO-07-513

The Draft Report's recommendations for executive action and responses to them are as follows:

"[T]o enhance the FSM and RMI trust fund committees' oversight of the trust funds, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the committees, to work with other U.S. agencies on the committees to undertake the following actions:"

1. "Develop strategies to improve the timeliness of the committees' decision-making and administrative processes."

Response: Agree. We believe that the current decisionmaking and administrative processes should be evaluated; discussions will begin at the next committee meetings in May 2007. The development and implementation of strategies will be an ongoing activity and part of the overall management of the trust fund.

The current arrangement under the Compacts requires the trust fund committees to act on all issues relating to the management of the trust funds, no matter how mundane. Current practice is also to have the U.S. delegation address these issues separately and reach consensus before they are addressed by the trust fund committees. This approach is difficult to reconcile in practice with the objective of allowing decisions to be made expeditiously for the purpose of effectively managing the trust funds. We note that the trust funds created in connection with the Palau Compact and Marshall Islands nuclear-affected atolls are managed without management committees in accordance with certain prudent requirements and do not face similar management issues.

Title of Responsible OIA Official: Deputy Assistant Secretary for Insular Affairs

Target Date: May 31, 2007

2. "Ensure the committees' timely reporting of trust fund activities, including assessing the funds' potential adequacy as an ongoing source of revenue and effectiveness in helping the countries achieve economic self-sufficiency and long-term budgetary self-reliance."

See comment 1.

Response: Generally agree. The trust fund committees should consider ways to ensure timely reporting. The identification of viable solutions will be discussed at the next committee meetings in May 2007. Note however that, although we consider the countries' abilities to achieve economic self-sufficiency and budgetary self-reliance of paramount importance, the purpose of the trust funds is to provide an ongoing source of revenue to contribute to these objectives, but not to meet any specific payout goal or substitute for other efforts and initiatives under the Compacts.

Title of Responsible OIA Official: Deputy Assistant Secretary for Insular Affairs

Target Date: May 31, 2007

3. "Obtain a full and independent evaluation of the potential benefits and risks of using securitization to increase the trust fund balances."

Response: We agree. Options, including contracting for a study, will be discussed at the next committee meetings in May 2007 and at subsequent meetings.

Title of Responsible OIA Official: Deputy Assistant Secretary for Insular Affairs

Target Date: May 31, 2007

Following is GAO's comment on the Department of the Interior's letter, dated May 11, 2007.

GAO Comment

1. We added clarification that no minimum disbursement from the trust funds is required or guaranteed. However, the trust fund agreements establish the 2023 level of compact grants, fully adjusted for inflation, as the maximum amount of annual income available for disbursement. Therefore, we believe it is appropriate to undertake a projection of the likely disbursements against that benchmark.

   We modified our second recommendation to emphasize that the reports should assess the status of trust fund performance and likely disbursements. We believe that careful analysis of the trust funds each year will help establish realistic expectations. Such analysis will also inform the trust fund committees as they make investment decisions and FSM and RMI leaders as they set economic policies and undertake long-term fiscal planning.

Appendix VI: Comments from the Department of Health and Human Services

Note: GAO comment supplementing those in the report text appears at the end of this appendix.

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of the Assistant Secretary for Legislation

Washington, D.C. 20201

MAY 16 2007

David Gootnick
Director, International Affairs and Trade
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Gootnick:

Enclosed are the Department's comments on the U.S. Government Accountability Office's (GAO) draft report entitled, "Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income" (GAO-07-513).

The Department appreciates the opportunity to comment on this draft report before its publication.

Sincerely,

Rebecca Hemard

for Vincent J. Ventimiglia
Assistant Secretary for Legislation

GENERAL COMMENTS OF THE U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) ON THE U.S. GOVERNMENT ACCOUNTABILITY OFFICE'S (GAO) DRAFT REPORT: COMPACTS OF FREE ASSOCIATION: TRUST FUNDS FOR MICRONESIA AND THE MARSHALL ISLANDS MAY NOT PROVIDE SUSTAINABLE INCOME (GAO-07-513)

General Comments

The U.S. Department of Health and Human Services (HHS) is grateful for the opportunity to comment on the draft report from the Government Accountability Office (GAO) entitled *Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income.*

HHS believes the report accurately identifies the areas in which Committees for the Trust Funds for the people of the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) need to make improvements to work more efficiently. We agree with the findings of the *Report* regarding flaws in the management of the two Trust Funds:

- Contractual hurdles did delay the establishment of the Trust Funds and the full investment of their capital;
- Committee processes have taken more time than warranted;
- Progress Reports were lacking for 2004, and the Committees delivered them late in 2005; and
- The Progress Reports make no mention of the adequacy and effectiveness of the Trust Funds.

Addressing these problems in a creative manner will help to make more robust management of the Funds a reality, which could, in turn, help to maximize the returns earned by the Trust Funds. HHS concurs with GAO's findings on these points, and believes the hiring of a dedicated administrator for the two Trust Funds and the creation of a stronger coordination process among the members of the Trust Funds Committees, which should include more frequent meetings, should eliminate the time lags that have affected the ability of the Committees to make decisions, produce high-quality and timely reports and finalize contracts.

In addition, HHS agrees with the conclusion of the *Report* (echoed in earlier GAO documents) that the FSM and the RMI must prepare now for the end of the current revenue stream under the Compacts of Free Association after 2023 by introducing important, structural changes and reforming their fiscal policies. The GAO *Report* suggests several options that would supplement the Trust Funds, the most important of which would be to implement changes in the islands' tax systems and to reduce the size of government. HHS strongly supports the promotion of economic development in the two nations, particularly through policies that encourage entrepreneurship, foreign investment and the growth of the private sector, as well as the training of a local workforce with the professional and technical skill sets critical to a dynamic economy (doctors, lawyers, administrators, and tradesmen, for example).

See comment 1.

GENERAL COMMENTS OF THE U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES (HHS) ON THE U.S. GOVERNMENT ACCOUNTABILITY OFFICE'S (GAO) DRAFT REPORT: COMPACTS OF FREE ASSOCIATION: TRUST FUNDS FOR MICRONESIA AND THE MARSHALL ISLANDS MAY NOT PROVIDE SUSTAINABLE INCOME (GAO-07-513)

On the issue of securitizing the Trust Funds, HHS welcomes the recommendation of the *Report* to "obtain a full and independent evaluation of the potential benefits and risks of using securitization to increase trust fund balances" and would fully endorse the launch of such a study. While we understand securitization could require explicit authority from the U.S. Congress, we believe it is a fiduciary responsibility of the two Trust Fund Committees to pursue every legally permissible avenue to maximize the Trust Funds' income and long-term sustainability.

The only point in the GAO *Report* on which we would disagree is its assertion that the Trust Funds will be insufficient if the income they generate "fall(s) short of the maximum allowed disbursement levels after the compact grants end in 2023." On this point, the *Report* reflects a fundamental misunderstanding of the outcome of the negotiation of the Amended Compacts of Free Association between the United States, the FSM, and the RMI, which, as spelled out in Article 3 of the two trust fund agreements, "is to contribute to the economic advancement and long term budgetary self-reliance," not to guarantee a certain level of income. So long as the trust funds are a source of annual revenue at all, they have met their agreed and stated purpose.

We hope that this information is useful to you. Please do not hesitate to contact us if we can be of further assistance.

Following is GAO's comment on the Department of Health and Human Services' letter, dated May 16, 2007.

GAO Comment

1. We strongly disagree with HHS' assertion that our report reflects a fundamental misunderstanding of the outcome of the negotiation of the amended compacts. We clearly stated the purpose of the trust funds is to provide an ongoing source of revenue for the FSM and the RMI. Furthermore, we added clarification that no minimum disbursement from the trust funds is required or guaranteed. However, the trust fund agreements establish the 2023 level of compact grants, fully adjusted for inflation, as the maximum amount of annual income available for disbursement. Therefore, we believe it is appropriate to undertake a projection of the likely disbursements against that benchmark.

   We modified our second recommendation to emphasize that the reports should assess the status of trust fund performance and likely disbursements rather than the adequacy of the funds to ensure we do not imply any required level of minimum income. We believe that careful analysis of the trust funds each year will help establish realistic expectations. Such analysis will also provide information to the trust fund committees as they make investment decisions and to FSM and RMI leaders as they set economic policies and undertake long-term fiscal planning.

   HHS noted that "so long as the trust funds are a source of annual revenue at all, they have met their agreed and stated purpose." For the trust fund committees to be assured of achieving such a purpose, the trust funds would have to be invested in low-risk, low-yield government bonds after 2023. This would ensure that the trust funds will provide some level of disbursement to the FSM and the RMI. The income from the funds will not reach the maximum level of disbursement allowed and will diminish in real value over time. Our analysis shows that right after the grants expire, the funds will be able to disburse about 50 percent and 68 percent of the 2023 grant levels for the FSM and the RMI respectively with the ratios getting smaller over time.[1]

[1]We used the estimated median account balance in 2023 under the most aggressive strategy as a starting point for investment in government bonds.

Appendix VII: Comments from the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of State

Assistant Secretary for Resource Management and Chief Financial Officer

Washington, D.C. 20520

MAY 15 2007

Ms. Jacquelyn Williams-Bridgers
Managing Director
International Affairs and Trade
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548-0001

Dear Ms. Williams-Bridgers:

We appreciate the opportunity to review your draft report, "COMPACTS OF FREE ASSOCIATION: Trust Funds for Micronesia and Marshall Islands May Not Provide Sustainable Income," GAO Job Code 320439.

The enclosed Department of State comments are provided for incorporation with this letter as an appendix to the final report.

If you have any questions concerning this response, please contact Mary Comfort, Attorney Adviser, Office of the Legal Adviser, at (202) 647-1121.

Sincerely,

Bradford R. Higgins

cc: GAO – Emil Frieberg
EAP – Christopher Hill
State/OIG – Mark Duda

U.S. Department of State's Comments on GAO Draft Report
Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income
(GAO-07-513)

Thank you for the opportunity to comment on the draft report *Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income.*

See comment 1.

The Department of State has an important role in the implementation of the Amended Compacts of Free Association between the United States and the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI), including the implementation of the trust fund agreements. We strongly disagree with the implication that runs through the report that the trust funds will not have met their stated and agreed purpose unless they generate a level of income from and after 2024 that equals the level of 2023 grant assistance plus inflation. Such a reading of the trust fund agreements is not justified by the terms of the agreements and is not consistent with the negotiations that led to the agreements.

The assistance format agreed to between the United States and the two Freely Associated States after several years of negotiation, and reflected in the final binding international agreements, was a decrease in annual grant assistance over 20 years, with the decrement to be placed in trust funds for the benefit of the FSM and RMI respectively. Although the FSM and RMI would have liked the final agreements to contain some level of assurance or expectation that the trust funds would generate annual revenue comparable to the annual grant assistance received from 2004 to 2023, the United States refused to include any such assurances, or countenance any such expectations. Thus, the agreed purpose of the trust funds, as spelled out in Article 3 of the two trust fund agreements, "is to contribute to the economic advancement and long-term budgetary self-reliance" of the two FAS "*by providing an annual source of revenue*, after Fiscal Year 2023, for assistance" in specified sectors, with priorities in education and health care (emphasis added). So long as the trust funds are *a* source of annual revenue, they have met their agreed and stated purpose.

See comment 2.

The GAO report, however, from its title to its conclusion, judges the trust funds by whether, starting in 2024, they will generate annual revenue at the 2023 annual grant level plus inflation. The report repeatedly questions the "adequacy" of the funds to replace expiring grants and the ability of the funds to sustain the maximum disbursement levels allowed, and judges the trust funds against these standards that do not reflect the agreements reached between the United States and the two FAS. This is a dangerous misreading of the international agreements and is likely to build up unwarranted expectations that are not supported by the agreements reached. This is acceptable to the extent that the goal of the analysis is to encourage the two FAS not to count on an unrealistically large income stream coming from the trust funds, but the overwhelming impression left by the report is that the trust funds will have failed in their purpose if they do not generate annual revenue sufficient to replace the expiring grants plus inflation. This viewpoint is contrary to the actual agreement reached between the United States and the FSM and the RMI when they designed the trust funds.

See comment 3.

Along these lines, in the "What GAO Found" section of the cover sheet, and on pages 5 and 28, the report lists four possible ways to enhance the trust funds' income. A fifth should be added. Although after 2023 the Trust Fund Committee *may* disburse to the FSM and RMI annual payments of up to the 2023 annual grant amount plus inflation, there is no requirement that they request that amount. Thus, a fifth strategy for enhancing the trust funds' income would be for the two FAS to allow the fund to grow further by refraining from requesting the withdrawal of the full allowable amount each year.

See comment 4.

Following are GAO's comments on the Department of State's letter, dated May 15, 2007.

GAO Comments

1. We strongly disagree with State's assertion that our reading of the trust fund agreements is not justified by the terms of the agreements and is not consistent with the negations that lead to the agreements. We clearly stated the purpose of the trust funds is to provide an ongoing source of revenue for the FSM and the RMI. Furthermore, we added clarification that no minimum disbursement from the trust funds is required or guaranteed. However, the trust fund agreements establish the 2023 level of compact grants, fully adjusted for inflation, as the maximum amount of annual income available for disbursement. Therefore, we believe it is appropriate to undertake a projection of the likely disbursements against that benchmark.

   We modified our second recommendation to emphasize that the reports should assess the status of trust fund performance and likely disbursements rather than the adequacy of the funds to ensure we do not imply any required level of minimum income. We believe that careful analysis of the trust funds each year will help establish realistic expectations. Such analysis will also provide information to the trust fund committees as they make investment decisions and to FSM and RMI leaders as they set economic policies and undertake long-term fiscal planning.

2. State commented that "so long as the trust funds are a source of annual revenue at all, they have met their agreed and stated purpose." For the trust fund committees to be assured of achieving such a purpose, the trust funds would have to be invested in low-risk, low-yield government bonds after 2023. This would ensure that the trust funds will provide some level of disbursement to the FSM and the RMI. The income from the funds will not reach the maximum level of disbursement allowed and will diminish in real value over time. Our analysis shows that right after the grants expire, the funds will be able to disburse about 50 percent and 68 percent of the 2023 grant levels for the FSM and the RMI respectively with the ratios getting smaller over time.[1]

[1]We used the estimated median account balance in 2023 under the most aggressive strategy as a starting point for investment in government bonds.

3. We disagree with State's characterizing our assessment of the trust funds' likely capacity to provide revenue to the governments of the FSM and the RMI as "likely to build up unwarranted expectations." On the contrary, we believe that careful analysis of the funds' probable income will help build realistic expectations and provide invaluable inputs for policymakers in formulating economic policies and long-term plans. It is to this end that we recommend that the trust fund committees assess the funds' status as an ongoing source of revenue and effectiveness in helping the countries achieve economic self-sufficiency and long-term budgetary self-reliance.

4. State suggested a fifth strategy for enhancing the trust funds' income would e for the countries to allow the fund to grow further by refraining from requesting the withdrawal of the full allowable amount each year. We analyzed the option of not disbursing the maximum allowed income (see app. III). We compared the likelihood of not reaching the maximum level allowed when all income is disbursed versus when some income is reinvested. Our analysis shows while the benefit of the reinvested trust fund income helps improve the prospect of the trust funds in later years, the disbursement in earlier years will be lower.

Appendix VIII: Comments from the Federated States of Micronesia

EMBASSY OF THE
FEDERATED STATES OF MICRONESIA
1725 N STREET, N.W.
WASHINGTON, D.C. 20036

TELEPHONE (202) 223-4383
TELEFAX: (202) 223-4391
www.fsmembassydc.org

June 01, 2007

Mr. David Gootnick
Director, International Affairs and Trade
United States Governmental Accountability Office
Washington, D.C. 20548

Dear Mr. Gootnick:

Thank you for the opportunity to review and comment on the GAO's draft report no. GAO-07-513, "Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income." The Government of the Federated States of Micronesia ("FSM") is in general agreement with the recommendations of GAO as stated in the draft Report.

As you know, while the Government of the Federated States of Micronesia ("FSM") occupies only two of the five seats on the Trust Fund Committee ("TFC"), this Trust Fund was negotiated from our side of the table to provide a smooth transition, in the year 2023, from the annual US grants into a regime of annual Trust Fund income that would equal or better the level of US grants at the time of the transition. We are aware that certain parties on the US side would now prefer to state that there was never such an undertaking by the US, and that the Trust Fund represents nothing more than a handshake by the US in 2023 to the FSM, with best wishes for the future. The Government of the Federated States of Micronesia strongly disagrees with this concept of the purpose of the Trust Fund.

Several of the things that are clear by now, having by now experienced so many unanticipated difficulties of coordination in making the fundamental organizational arrangements for the Fund, are that:

A. The task of launching the Fund with all the complexities and time-consuming procedural steps involved was more than the negotiators anticipated; and

B. The Fund, as a consequence, has lost substantial income at the critical beginning, with very negative consequences for the income-producing ability in 2023; and

C. Any of the alternatives proposed so far to try and catch up on the long-term effect of the early losses incurred, such as the proposed "securitization" carry risks of their own that need to be evaluated from an objective perspective.

None of these points are made to direct blame toward our partners within the US Government who have also worked hard to explore, along with us, this previously unexplored territory.

In the case of this draft Report, as with earlier Reports, the FSM welcomes the important contributions of the GAO.

Sincerely,

for

James A. Naich
Charge d'Affaires, ad interim

cc: FSM Foreign Affairs – Home Office
FSM OCM

Appendix IX: Comments from the Republic of the Marshall Islands

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

EMBASSY OF THE REPUBLIC OF THE MARSHALL ISLANDS
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May 18, 2007

Mr. David Gootnick
Director
International Affairs and Trade
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Gootnick

Thank you for providing the Draft GAO Report (GAO-07-513) "Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income" to the Government of the Republic of the Marshall Islands for review and to make comments (please see attached).

The RMI Government welcomes GAO's input and looks forward to continuing to work with the GAO in identifying and address issues particularly related to the Trust Fund for the people of the Republic of the Marshall Islands.

Sincerely,

Banny deBrum
Ambassador

- 1 -

Government of the Republic of the Marshall Islands
Comments on the GAO Report (GAO-07-513)
"Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income"

The following comments are based on a review of the draft document. The Republic of the Marshall Islands (RMI) would hope that the changes stated and observations made are clarified and reflected in the final report.[1]

General Comments:

The RMI would like to commend the GAO on an excellent report outlining many of the issues surrounding the implementation of the Compact Trust Fund and its likely sustainability.

See comment 1.

The RMI would like the report to consider the impact of full inflation adjustment of the contributions to the Compact Trust Fund (CTF). Full inflation adjustment has been a long-standing position of the RMI, since the Government believes that it would have a substantial impact on the sustainability of the CTF, if incorporated into the agreement.

Page 12: Trust Fund Governance (Annual Reports)

"The (annual) reports are to assess the effectiveness of the funds in contributing to the economic advancement and long-term budgetary self-reliance of the FSM and RMI"

See comment 2.

This requirement seems to only apply to the situation post-FY 2023, once the fund is scheduled to start disbursing funds. In the interim, the Compact Trust Fund (CTF) will have little or no impact on economic advancement and long-term budgetary self-reliance.

Page 18: Trust fund committee processes

The problems cited relating to the CTF administrative processes need to be resolved through the designation of responsibilities. If this requires external assistance then the Committee should seek this assistance. Article VIII of the Trust Fund Agreement allows the Committee to "obtain technical advisory services as needed and appropriate". This lack of designation of responsibilities is directly related to the fact that the RMI Trust Fund Committee "did not publish annual reports as required" (Page 20).

In setting up its Compact Implementation Office, the Ministry of Foreign Affairs intends to designate an officer with responsibility for Compact Trust Fund matters. Nevertheless, the RMI believes that the Committee should consider funding a Trust Fund Secretariat to be responsible for coordinating all reporting requirements of the Trust Fund Committee. This would include coordinating Annual Reports, Audit Reports and providing secretariat services for the Trust Fund Committee. The Committee should arrange for the approval of an annual administrative budget each year. The funding should come from the A Account of the CTF with an annual budget approved by the Trust Fund Committee.

[1] Page references may vary slightly from the GAO report.

Pages 21-23: Market Volatility Could Lead to Wide Range of Trust Fund Balances in 2023.

The presentation of the results from the various scenarios of investment strategies seems to suggest that the RMI has little downside risk from adopting an aggressive investment strategy. The comparison of the 10th percentile in each strategy (conservative, moderate and aggressive) indicates largely equal outcomes come 2023. However, the upside from adopting an aggressive strategy is substantial. The difference in the CTF balances in 2023 between a conservative and aggressive strategy, for the median results is $166 million, while the difference for the 90th percentile result is $538 million. This would seem to indicate a huge potential return on the upside by adopting an aggressive investment strategy (with little downside risk).

Pages 27-32: Several Options Exist for supplementing FSM and RMI Trust Fund Income

As mentioned above, the RMI believes that the CTF contributions should be fully adjusted for inflation. The report should possibly consider this as an option for supplementing the CTF income, since it has been the long-term stance of the RMI that contributions should be fully inflation adjusted.

Page 30: Trust Fund Securitization

The Government strongly supports investigating this option further and agrees with the recommendation that an "independent evaluation of the potential benefits and risks" of this option is needed. The Government believes, however, that to maximize the potential returns from securitization this investigation needs to take place at the earliest possible time.

Following are GAO's comments on the Republic of the Marshall Islands' letter, dated May 18, 2007.

GAO Comments

1. Our analysis was based on the current contribution structure. Under certain U.S. inflation conditions, contributions to the trust fund can be fully adjusted for inflation after 2014.

2. Although the trust fund will have little or no impact on the RMI's economy until disbursements from the fund begin, we believe that careful analysis of the fund's likely income will help build realistic expectations and provide invaluable information for policymakers in formulating economic policies and long-term plans. It is to this end that we recommend that the RMI trust fund committee assess the fund's status as an ongoing source of revenue and effectiveness in helping the country achieve economic self-sufficiency and long-term budgetary self-reliance.

Appendix X: GAO Contact and Staff Acknowledgments

GAO Contact

David Gootnick, (202) 512-3149 or gootnickd@gao.gov

Staff Acknowledgments

In addition to the individual above, Emil Friberg (Assistant Director) and Ming Chen made key contributions to this report. Muriel Brown, Lawrance Evans, Etana Finkler, Reid Lowe, Thomas McCool, Mary Moutsos, and Wilda Wong provided technical assistance.

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