RISK-BASED BANK SUPERVISION MANUAL

SEPTEMBER 2015
Efficiency of Banks in South-East Europe: With Special Reference to Kosovo

CBK Working Paper no. 4
In accordance with Article 36, paragraph 1, sub-paragraph 1.4 of the Law no. 03 / L-09 on the Central Bank of the Republic of Kosovo, and Article 16 of the Statute of the Central Bank of the Republic of Kosovo, the Executive Board, at its meeting held on August 13, 2015 approved the following:

RISK-BASED BANK SUPERVISION MANUAL

Prishtina, September 2015
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1. INTRODUCTION

The Central Bank of the Republic of Kosovo (CBK), consistent with other supervisors throughout the world, maintains that the purpose of financial system supervision is based on the following three principles:

- Protection of Depositors;
- Financial Stability;
- Efficient and Competitive Financial System.

Protection of depositors is perhaps the most fundamental reason for supervision and regulation of the financial system. A significant portion of the assets of individuals, businesses and of governments is held in banks institution.

In addition to concern about depositor safety, financial system supervision must also seek to provide a stable framework for making payments. A safe, acceptable and reliable payments system is essential to the health of the economy. Bank supervision and regulation should thus keep fluctuations in business activity and problems at individual institutions from interrupting the flow of transactions across the economy and threatening public confidence in the entire financial system.

Another aspect of an efficient financial system is that customers are provided quality services at competitive prices. Therefore, bank supervision and regulation should create and maintain a regulatory framework that encourages efficiency and competition and ensures an adequate level of financial services throughout the economy. It is also important that supervision and regulation of the financial sector takes an approach that does not needlessly restrict activities of commercial banks and other institutions, place them at a competitive disadvantage with other regulated firms, or hinders their ability to serve their customers’ credit and other financial needs. Lastly, supervision and regulation should foster a financial system that can adapt quickly to changing economic conditions, technological advances and supervisory approaches.

In line with international best practices, the CBK has revised its supervisory policies, practices and procedures in order to provide a dynamic, efficient, structured and risk-oriented prudential supervision framework. The result of this has been the adoption of the Risk Based Supervision (RBS) approach.
RBS is a structured, yet flexible, forward-looking process designed to identify, assess, measure, monitor and control/reduce/mitigate key risk factors to which individual banks and the entire financial industry are exposed. By using an RBS approach, supervisors assess risk management policies and practices used by banks to control/reduce/mitigate risk. RBS focuses the level of supervisory attention on those risk areas that pose the greatest risk to the banks’ safety and soundness. RBS also supports the CBK in achieving its regulatory objectives, while taking into account the need to employ its resources in the most efficient and effective manner.

RBS provides supervisors the means and the tools to systematically consider all key functional activities (business lines or operational areas) of banks and, within each key functional area, evaluate the level of risk, quality of risk management, and direction of risk (increasing, decreasing or remaining stable). This results in the development of a Risk Profile for the bank.

This manual facilitates consistent supervisory treatment of banks by CBK’s Bank Supervision Department (BSD) staff and will be utilized by staff as a training tool and as a reference manual. It is expected that the manual will be updated periodically to maintain pace with changes in the Kosovo banking industry.
2. PURPOSE OF The MANUAL

The purpose of this manual is to organize and formalize the supervisory objectives and procedures that provide guidance to the CBK’s bank examiners, and to enhance the quality and consistent application of supervisory procedures. The manual provides specific guidelines for:

- Determining and setting the supervisory strategy for each bank;
- Determining the procedures to be used in examining all areas of a bank, including those procedures that may lead to the early detection of trends that, if continued, might result in a deterioration in the condition of the bank;
- Evaluating the adequacy of the institution’s risk management practices and procedures, and the degree of compliance with them;
- Evaluating the overall performance and activities of management and the BOD of directors;
- Preparing work papers that support conclusions reached and aid in evaluating the work performed;
- Using objective criteria as a basis for the overall conclusions and for the resulting comments and criticisms contained in the Report of Examination (ROE) regarding the condition and quality of the bank and its management.

Examiners are encouraged to use this manual as a working guide as well as a reference manual. In most sections of the manual, procedures are provided to form the basis for the supervisory process of each individual bank. These procedures are intended to lead to consistent and objective supervision of each institution. Examiners should be able to increase the level of professionalism and the soundness of the financial system by encouraging each bank to follow best practices that currently exist in the industry. In no case, however, should this approach discourage the development and implementation of conceptually sound and innovative practices by individual institutions.
3. THE RISK BASED SUPERVISORY PROCESS

The supervisory process is a full cycle. It is a continuous and dynamic process consisting of the following steps:

1. **Understanding the Institution** – Understanding the Institution’s unique characteristics, corporate culture and risk profile;

2. **Assessing the Institution’s Risks** – Focusing supervisory efforts on those risks posing the most severe challenge to the safety and soundness of an institution according to the bank’s risk profile;

3. **Planning / Scheduling Supervisory Work** - Developing a plan reflective of supervisory concerns and how they are being, or will be, addressed;

4. **Defining Examination Activities** – Detailing procedures and activities to be performed;

5. **Performing On-Site Examination** – Testing and validating data provided by the institution; and,

6. **On-Going Off-Site Supervision** – An on-going process which includes periodic off-site analysis of information submitted by the banks and other events that may affect the over-all condition of an institution.

To enable the CBK to meet its supervisory objectives and to implement the supervisory cycle, the responsibility of regulating and supervising banks is done mainly by the Bank Supervision Department (BSD). The BSD is currently organized into three divisions: On-Site Supervision, Reporting and Analysis i.e., Off-Site), and Micro-Financial Institutions and Non-Bank Financial Institutions. The on-site supervision division is responsible for on-site examinations. The reporting and analysis division is responsible for performing off-site reviews, both on a macro and on a micro or individual bank basis. The micro-financial and non-bank financial institutions division carries out the on-site examinations of the micro-financial institutions.

The focus should be on fully achieving a risk focused and coordinated supervisory process. The content and format of the products produced by the BSD staff are flexible and should be adopted to correspond to the supervisory practices of the CBK and the structure and complexity of the institutions. The relationships between the six stages of the risk-based supervisory process, and their specific deliverables, are illustrated in the following diagram:
Scheme 1. Risk-Based Supervision Conceptual Framework

1. Understanding the institution
   - Institutional Profile

2. Assessing the Institution’s Risk
   - Risk Matrix
   - Risk assessment narrative

3. Planning and Scheduling Supervisory Activities
   - Supervisory Plan

4. Defining Examination Activities
   - Supervisory Memorandum

5. Performing On-site Examination
   - Examination Reports

6. Conducting Off-site Supervision
   - Update Institutional Profile. Monitor bank’s activities between o-site exams
3.1. **STEP 1 – UNDERSTANDING THE BANKING INSTITUTION**

3.1.1. **Objectives**

- To gain and maintain an understanding of the bank – its risk profile and management practices;
- To develop the basis for structuring an appropriate supervisory strategy for the bank.

3.1.2. **Background**

The starting point for Risk Based Supervision (RBS) of each bank is developing an understanding of the institution, its management and banking practices. This step is critical to tailoring the supervisory strategy to meet the characteristics of each bank and adjusting that strategy on an on-going, as needed, basis as circumstances change. Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the bank and related supervisory concerns associated with those risks.

Given the technological and market developments within the economic sector in Kosovo and the speed with which bank’s financial conditions and risk profile can change, it is critical to keep abreast of events and changes in the bank’s risk profile and to make the necessary changes to the supervisory strategy for the bank. In view of this, the CBK will ensure that the bank’s Institutional Overview (Appendix I) is prepared and updated at least quarterly.

The bank’s Institutional Overview should provide a summary that communicates, in a concise form, information demonstrating an understanding of the bank’s present condition and highlights key issues, including past supervisory findings and concerns. The overview should provide a summary of the bank’s structure, financial condition, and its current and prospective risk profile. Furthermore, the overview will contain information pertaining to the ownership, capital and group structure (where applicable), branch network, staffing, corporate governance systems, the bank’s business profile and strategy, risks and challenges facing the institution, and regulatory and any other ratings.

Information for compiling and updating the bank’s Institutional Overview should be collected from reliable sources available to the examiners. These sources will include on-site examination reports, regular prudential and statutory returns, *ad-hoc* returns,
published financial results, external rating agency reports, formal and informal meetings with the bank’s BOD of Directors (BOD) and senior management, internal and external auditors, and reports of and/or meetings with other supervisory/regulatory authorities.

Other sources of information may include media reports, market intelligence (information about the competition in the market), and complaints filed against the bank.

3.1.3. Procedures

I. Gather information to complete and/or update the bank’s Institutional Overview.

A. Review the Reports of Examination (ROE), assessment by risks, CAMELS dhe CAELS.

B. Review the documents related to any CBK decision where it is specified the measures that the bank should apply.

C. Review the bank’s correspondence file for relevant information: letters between the CBK and the bank; clippings from newspapers that relate to the activities of the bank and its personnel; adverse publicity; adverse economic events in the community; natural disasters; death or disappearance of senior manager; large financial commitments as a sponsor or lead institution in a major project or development, etc.

D. Contact licensing division staff for information regarding recently approved or pending applications for the bank. Review applications, as deemed necessary for a merger, acquisition, or establishment of a new branch or subsidiary.

E. Review bank’s data for significant information that could cause a change in its risk profile (change in external auditors, large defalcation, large pay down or payoff of previously classified loans).

II. Complete and/or update the bank’s Institution Overview.

A. Overall Condition: Summarize the overall condition of the bank, based on the level of concern, assessment of risk management systems and adequacy of management oversight. Any key issue (concern) relating to the strategies employed should be highlighted.

B. Corporate Overview:
1. Background: Summarize the history of the bank. Include its date of establishment, name changes (if any), mergers and acquisitions, conversions of license, etc.

2. Shareholding Structure: Indicate names of shareholders owning 10% or more of the outstanding shares, number of shares held and percentage shareholding over the past three years. If the bank is owned by a holding or parent company, this is also shown for the holding company or parent’s shareholding structure – to the extent known. Specify country for any foreign owners. (Review annual reports of the holding company or parent company to obtain this information.)

3. Capital Structure: List the bank’s capital components over the past three years in tabular form including capital adequacy ratios.

4. Related Organizations: Present in tabular form, the bank’s subsidiaries, affiliates, and any other related organization showing the percentage owned by the bank of each – or how the organization is related.

5. Vision, Mission, and Strategy: State the bank’s vision, mission, values, and strategic goals and initiatives. Comment on the potential risks associated with the bank’s strategic initiatives, forecasts, projections for key performance areas, budget projections, and/or new markets and products.

6. Key Functional Lines: Identify the bank’s key functional lines and products offered in each line. Also include major support services such as Information and Communications Technology (ICT).

7. Risk Management Framework: Provide details of the risk management structures, systems, and procedures used to manage the various risks inherent in the bank’s operations. If a foreign bank owner is responsible for establishing and implementing the risk management systems, provide details regarding the Kosovo bank’s involvement in reviewing and adjusting the systems to address their specific institution risk appetite and risk profile. The roles and responsibilities of individuals and departments involved in the risk management process should be clearly articulated. BOD and senior management reports, limits in place and IT Systems capabilities should be covered.

8. Branch Network: Indicate the number of branches, agencies, and other points of representation and their respective physical addresses.

9. Staff Complement: State the total number of bank employees, indicating managerial and non-managerial staff. Where necessary, comment on the adequacy of the human capital particularly in key operational areas, in
respects of numbers, qualifications, and skills. Discuss any concerns regarding employee turnover.

10. External Auditors and Lawyers: Show the names, addresses, telephone numbers and the auditor and attorney in charge and indicate the number of years these auditors and attorneys have provided service to the bank. In addition, take note of other consultancy assignments the auditor or law firm may have undertaken for the bank.

11. BOD of Directors (BOD): Present in tabular form, the names, ages, occupations, qualifications, experience, and other directorships of all the BOD members and companies in which they hold shares. Further, BOD members must disclose explicitly any other business relationships that they or their spouses have with the bank or its subsidiaries.

12. Senior Management: Present in tabular form, the names, ages, qualifications, and experience of all senior managers and companies in which they hold shares. Further, senior management must disclose explicitly any other business relationships they or their spouses have with the bank or its subsidiaries.

13. BOD Committees: State the compositions of the various BOD committees and their terms of reference. Comment on any irregularities; i.e., non-attendance by a member, not holding regular meetings, domination by one member, etc.

14. Management Committees: State the compositions of the various management committees and their terms of reference. Comment on any irregularities (see examples listed in 13 above).

15. Overview of management: Comment on the adequacy of the BOD and management oversight in terms of:

   a. the overall risk management framework;
   b. policies and procedures in key risk areas;
   c. internal control systems; and,
   d. strategic planning and policy formation.

   Also comment on the management information systems (MIS) in terms of reliability and timely production of financial and/or regulatory reports.

16. Twenty Largest Borrowers: Present in tabular form, the twenty largest borrowers showing the counterparty, limit, current balance, and maturity date, nature of exposure, and security type. Further, show the amount outstanding for each borrower as a percentage of regulatory capital.
17. Twenty Largest Depositors: Present in tabular form, the twenty largest depositors showing name of client, amount, type of deposit, and the cost of borrowing.

18. Industry Rankings: Present in tabular form, the bank’s position in relation to other banks in Kosovo. Show total deposits, total loans, and total assets by amount, percentage, and market share. Also include total capital and risk-weighted capital adequacy ratio.

C. Examination Results, Audit Findings and External Credit Rating:

1. Results of Past On-Site Examinations: Present in tabular form, the results of the last three on-site examinations showing the respective overall and CAMELS ratings as well as risk ratings.

2. Significant Findings of Last On-Site Examination: Summarize the significant finding of the last on-site examination.

3. External and Internal Audit Findings: Summarize the significant findings of the most recent external and internal audits, and highlights of prudential meetings with the auditors.

4. External Credit Rating: Indicate the latest ratings obtained by the bank for itself or parent or holding company. Provide the rating, the date it was assigned, and the name of the rating company or agency.

D. Periodical analysis from off-site examination:

Provide a summary of the overall conclusions of the bank based on the most recent financial returns, and comment on the following areas:

1. D1 – Capital Adequacy;
2. D2 – Asset Quality;
3. D3 – Management;
4. D4 – Earnings;
5. D5 – Liquidity and Funds Management;

E. Violations of Law and Non-Compliance with Regulatory and Supervisory Requirements:
Comment on the bank’s compliance with the Law on Banks and Micro-Financial Institutions and rules, regulations, and directives issued by the CBK. State any violations noted and action taken or to be taken.

F. Environmental Considerations:

Identify and comment on any external environmental factors which may have an adverse impact on the operations and condition of the bank; for example, property, debt and equity markets, and other significant economic conditions.

G. Financial Stability and Stress Testing Assessment:

1. Financial Stability Considerations: Comment on the bank’s financial performance, brand strength, weaknesses, and the contagion effect on the financial system, in the event of default.
2. State the assumptions and results of stress tests conducted by the CBK’s BSD, the Financial Stability Department and by the bank itself.

3.1.4. Appendix I – 1: Sample (example) on core knowledge of the bank/specific information (core knowledge)
Date: day-month-year

Name of the bank: xxxxxx
Address of the bank: xxx, no.xx, Prishtina, Kosovo
Date when the core knowledge were acquired: day-month-year
Prepared by: xxxxx xxxxxx – responsible examiner for XXX
Last update: day-month-year

Bank profile

(Assessments of examination shape the form for the next supervisory activity. Some of these assessments are included in the profile of core knowledge. Once you complete the profile, summarize the data presented in here. Update the profile, if necessary in the middle of examination and always prior each examination.)

Bank history

(Date of licensing, date opened for business, mergers or acquisitions, number of branches, name and activity or type of business of subsidiaries and subordinated entity, if the subsidiaries are not fully owned, including the names and percentage of ownership of other owners, pending applications of corporate).

Assessment and history of supervision (examinations)

(List assessments by risks, CAMELS and components of assessment for 5 last examinations and any important issues that required attention of the board or management, If any important issue was identified or if the bank is under any action document of supervision, note the corrective actions undertaken for monitoring by the supervision. If under foreign ownership, include in here the information obtained from foreign supervisors.)
Ownership

(List the important shareholders (> 25% shares owned), their percentage of ownership, main interests in their businesses and any position held in the bank (director or other managing position). If the shareholder is another bank or financial service entity, note whether the entity is foreign-owned and if so, note the country of origin of the ownership, its external supervisor and its structure of ownership, e.g. whether its shares are publicly traded, any significant shareholder.)

Board and structure of the board

(List the current directors, percentage of ownership, their professions and functions in board committees, such as: the audit committee, the risk committee, etc. Describe the structure of the board such as: managing board and executive board.)

Main management positions and organizational structure

(List 5-10 upper management positions and identify individually what include these positions. List in details the total compensation for each key position and how are defined the bonuses, performance, growth or is it based on seniority. Describe the organizational structure and culture, therefore, are the decisions made based on hierarchy, committees, or otherwise, are the communications open or controlled, etc.)

Control environment

(Discuss the program or the function of quality control of the bank, functions of internal and external audit and relation of reporting structure as it can be with the management or the board or its committees, adequacy of the audit, scope, testing, and note current external audit company. Note the locations of supporting buildings of information technology, information technology support and services. Discuss the physical security measures of the buildings (need for codes-passwords for visitors during the examination, access to the bank electronic system by examiners, etc.)

Corporate culture of the bank and risk tolerance

(Does the bank refuse, tolerate or accept the risks? Does the bank have strategic plan. Goal or vision of corporation? How the policy changes are communicated to clients and employees? How is the bank seen by the competitors - leader, innovative, trending bank, etc.)
Bank products, services and markets

(Describe the main products and services of the bank, emphasizing the new products since the last examination and percentage of the balance sheet or revenues. Are the products and services developed and created directly from the bank or by an external person? Describe the bank's focus on markets and fields of service, e.g. global, regional, local and any issues related to the fields of market.)

3.1.5. Appendix I – 2: Sample (example) on bank risk profile)
## BANK RISK PROFILE: xxxxxxxxx

<table>
<thead>
<tr>
<th><strong>Name of the bank:</strong> xxxxxxx</th>
<th><strong>Financial information</strong> (day-month-year):</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Address:</strong> Street: “xxxx”, No. xx, Prishtina.</td>
<td>- Total assets: xxx million euro.</td>
</tr>
<tr>
<td><strong>Bank’s point of contact:</strong> Xxxxxx XxxxxX telephone (038-XXX-XXX) ext: xxx</td>
<td>- Total gross loans: xxx million euro.</td>
</tr>
<tr>
<td><strong>Chief executive officer:</strong> Xxxxxx XxxxxX</td>
<td>- Total deposits: xxx million euro.</td>
</tr>
<tr>
<td><strong>Initial date of preparing the bank risk profile:</strong> day-month-year</td>
<td>- Total borrowings: xxx million euro.</td>
</tr>
<tr>
<td></td>
<td>- Net profits: xx million euro</td>
</tr>
<tr>
<td></td>
<td>- ROAA: xx.x%</td>
</tr>
<tr>
<td></td>
<td>- Loan loss reserves / non-performing loans: xxx.x%.</td>
</tr>
<tr>
<td></td>
<td>- Past due loans / total loans: x.x%.</td>
</tr>
<tr>
<td></td>
<td>- Classified loans (problematic): / total loans: x.x%</td>
</tr>
</tbody>
</table>

**Type of last on-site examination:**
Complete examination / Focused examination

**Date of commencing the examination:**
day-month-year

**Date of concluding the examination:**
day-month-year

**Financial information of the date:**
day-month-year.
### Overall assessment of the bank:

<table>
<thead>
<tr>
<th>Date of commencing the examination</th>
<th>Actual examination</th>
<th>Prior examination</th>
<th>Prior examination (t-2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination of financial data up to</td>
<td>Day-month-year</td>
<td>Day-month-year</td>
<td>Day-month-year</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall assessment</th>
<th>X</th>
<th>X</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of components:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Quality of assets</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Management</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Profits</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Liquidity</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Sensitivity to market risk</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

### BIOGRAPHY AND STRUCTURE OF THE xxxxx BANK

(Date of licensing, participation in the banking sector, ownership structure, parent company and participation in group, share capital, branches, number of employees, etc.)

### BANK PROFILE AND ITS STRATEGY

(Licensing date, participation of the main indicators in the banking sector, mention any specific product that is provided, the purpose of crediting in certain sectors, crediting in the sector and the highest focus.)

**Specifics of the bank** - (Bank is managed by Xxxxxxx XXXXX – chief executive officer and by Xxxxxx XXXXXXX – deputy/ chief executive officer.

**Main changes in the bank since the period of the last examination of financial information: day-month-year.**

(specify the changes at the members of the board of directors and upper management)

### ASSESSMENT ACCORDING TO CAMELS SYSTEM SINCE THE LAST EXAMINATION OF THE DATE: day-month-year
Overall bank risk profile: comment

Capital adequacy  
*Rationale for the assessment:*

Credit risk and quality of assets  
*Rationale for the assessment:*

Management / Governance  
*Rationale for the assessment:*

Profits  
*Rationale for the assessment:*

Liquidity risk  
*Rationale for the assessment:*

Sensitivity to market risk  
*Rationale for the assessment:*

Operational risk  
*Rationale for the assessment:*

Internal controls  
*Rationale for the assessment:*

Internal auditing  
*Rationale for the assessment:*

Compliance with CBK's recommendations from the last examination  
*Rationale for the assessment:*

Focused examination during the month: day-month-year  
*Rationale for the assessment:*

BANK PROFILE BASED ON CAELS3 RATING SYSTEM OF THE DATE: day-month-year

*(rationale for assessing the overall risk of the bank)*

The table below reflects the current risk profile of the bank:
Risk profile of the bank xxx on the date day-month-year

<table>
<thead>
<tr>
<th>Risk category</th>
<th>Amount of inherent risk</th>
<th>Risk Management Quality</th>
<th>Overall level of risk</th>
<th>Direction of the risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit risk</td>
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<tr>
<td>Liquidity risk</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Sensitivity to market risk</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Operational risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Capital**

*Rationale for the assessment:*

**Quality of assets/credit risk**

*Rationale for the assessment:*

**Profits**

*Rationale for the assessment:*

**Liquidity**

*Rationale for the assessment:*

**Market risk**

*Rationale for the assessment:*

**Operational risk**

*Rationale for the assessment:*

**ASSESSMENT REGARDING MACRO PRUDENTIAL STABILITY**

**Banking sector and economy of Kosovo**

*(Based on information from organizational units within the CBK, responsible for macro-prudential stability)*

26 |
External environment (economy) where the parent company (bank) operates
Assessment:

FORECASTS AND RESULTS OF STRESS TESTS OF BSD: day-month-year

Below is presented a summary of the stress test results - XXX Bank solvency on the
date day-month-year:

(Present the table summarizing the stress-test results)

GOAL AND STRATEGY OF BANKING SUPERVISION
Assessment:

STEP 2 – ASSESSING THE INSTITUTION’S RISKS

3.1.6. Objectives

- Determine the strengths and weaknesses of the bank.
- Set the foundation by developing the bank’s risk profile and risk matrix for
determining supervisory activities to be conducted.

3.1.7. Background

In order to focus supervisory activities on the areas of greatest risk to an institution,
the central point of contact or designated staff personnel should perform a risk
assessment. The risk assessment highlights both the strengths and weaknesses of an
institution and provides a foundation for determining the supervisory activities to be
conducted. Further, the assessment should apply to the entire spectrum of risks facing
an institution, including:

1) **Credit Risk** – the potential that a borrower or counterparty will fail to perform
   on an obligation.

2) **Market Risk** – the risk to an institution’s condition resulting from adverse
   movements in market rates or prices, such as interest rates, foreign exchange
   rates, or equity prices.

3) **Liquidity Risk** – which is the potential that an institution will be unable to
   meet its obligations as they come due because of an inability to liquidate
   assets or obtain adequate funding (referred to as ‘funding liquidity risk”) or
   that it cannot easily unwind or offset specific exposures without significantly
   lowering market prices because of inadequate market depth or market
   disruptions (“market liquidity risk”).
4) **Operational Risk** – the potential that inadequate information system, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

5) **Country and Transfer Risk** - the risk that economic, social, and political conditions and events in a foreign country will affect an institution.

An institution’s business activities present various combinations and concentrations of these risks depending on the nature and scope of the particular activity. Therefore when conducting the risk assessment, consideration must be given to the institution’s overall risk environment, the reliability of its internal risk management program, the adequacy of its information technology systems, and the risks associated with each of its significant business activities.

The starting point in the risk assessment process is an evaluation of the institution’s risk tolerance and management’s perception of the institution’s strengths and weaknesses. Such an evaluation should include discussions with management and review of supporting documents, strategic plans, and policy statements. In general, management is expected to have a clear understanding of both the institution’s markets and the general banking environment and how these factors affect the institution (for instance, use of its technology, products, and delivery channels).

In assessing the overall risk environment of an institution, the central point of contact should make a preliminary evaluation of the institution’s internal risk management. This includes an assessment of the adequacy of the institution’s internal audit, loan review, and compliance functions. External audits also provide important information regarding the risk profile and condition of the institution that may be used in the risk assessment.

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by MIS that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization (i.e., the bank and any subsidiaries). Such MIS must also provide managers engaged in the daily management of the organization’s activities with regular and sufficiently detailed reports for their area of responsibility.

The CBK uses a Risk Matrix to summarize the level of risks inherent in an institution’s activities. This matrix also summarizes the quality of the risk management function in controlling or mitigating such risks and identifies the direction (i.e., ↑, ↓, or ↔) of those risks after taking into account both internal and external factors which may affect the institution’s risk profile. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and serves as a basis for preparation of the narrative risk assessment.
The matrix serves as a basis for preparation of the risk assessment summary. A sample risk matrix is presented in Appendix II: Risk Matrix.

The following steps will guide the examiners in preparing the Risk Matrix.

1) Identification of Significant Activities/Functional Areas

Significant activities include any significant line of business, unit or process. Significant activities are identified from various sources including institution’s organization chart, strategic business plan, capital allocations, and internal and external financial reporting such as balance sheet and income statement.

Identification of significant activities is important for determining the risks inherent in the activities of the institution. For the purpose of risk assessment, CBK has identified the most common risks namely, credit, liquidity, market, country or transfer and operational risks which should be mapped onto such significant activities in order to assist examiners identifying the risks inherent in each activity.

2) Determination of the Quantity of Inherent Risks

After the significant activities are identified, the quantity of risk inherent in those activities should be determined. If the institution uses other risk categories in addition to those defined by CBK, the examiner should ensure that such additional risk categories are captured under the categories used by CBK.

CBK has developed qualitative and quantitative criteria to be used for assessing the quantity of risks inherent in an institution. For each type of risk (with the exception of operational risk) there are selected quantitative criteria in which benchmarks have been established to determine the risk score of each criterion. For other criteria, judgmental assessment will be used to determine the risk score, which will be combined to come to a single risk score. The overall level of risk will be determined using the average risk rating for each criterion. There are three levels of risks: low, moderate, and high. The three levels are defined as follows:

a. High inherent risk exists when there is a higher than average probability of an adverse impact on an institution’s capital or earnings due to exposure and uncertainty from potential future events.
b. Moderate inherent risk exists when there is an average probability of an adverse impact on an institution’s capital or earnings due to exposure and uncertainty from potential future events.
c. Low inherent risk exists when there is a lower than average probability of an adverse impact on an institution’s capital or earnings due to exposure and uncertainty from potential future events.

It is important to remember that assessment of the quantity of risk is made without considering management processes and controls; rather, these factors are considered in evaluating the quality of the institution’s risk management systems.

3) Assessment of the Quality of Risk Management:

When assessing the quality of an institution’s risk management for the inherent risks in the institution, the examiner should place primary consideration on findings related to the following key elements of a sound risk management system:

a) BOD and senior management oversight;

b) Policies, procedures, and limits;

c) Risk measurement, monitoring, and MIS; and;

d) Internal controls.

The examiner should assess the relative strength of the risk management processes and controls for each identified risk using the above four key elements. CBK has established various criteria for assessing each key element and a score is assigned based on a judgmental assessment. An overall rating of the quality of risk management will be determined using a simple average of the scores for the four key elements. Ratings for the quality of risk management should be rated as strong, acceptable, or weak. These ratings are defined as:

a. Strong risk management indicates that management effectively identifies, monitors and controls or mitigates all major types of risks inherent in the institution. The BOD and management participate in managing risks and ensuring that appropriate policies and limits exist, and that the BOD understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and MIS that provide the necessary information and analyses to make timely and appropriate responses to changing conditions and the internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the institution.
b. Acceptable risk management indicates that the institution’s risk management systems, although largely effective, may be lacking to some modest degree. The rating reflects management’s ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution’s business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall BOD and senior management oversight, policies and limits, risk monitoring procedures, reports, MIS and internal control systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.

c. Weak risk management indicates risk management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. This may be characterized by inadequate BOD and senior management oversight, policies, procedures and limits, poor monitoring and inadequate MIS. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

4) Determination of the Net Risk

The net risk for each risk category is determined by balancing the quantity of inherent risk with the quality of risk management systems in the institution. For example, credit risk may be determined to be inherently high in an institution, however, the probability and the magnitude of possible loss may be reduced by having very conservative loan appraisal standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with credit risk may be moderate. The following grid provides guidance on determining the net risk by balancing the observed quantity and degree of risk with the perceived strength of risk management systems.
Once the examiner has assessed the composite risk of each identified significant activity or function, an overall composite risk assessment should be made for preparing the scope of an on-site examination and for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix, and the evaluation of the overall composite risk is incorporated into the written risk assessment.

To facilitate consistency in the preparation of the risk matrix, general definitions of the level of net risk for risk categories are provided below:

a. A high net risk would generally be assigned to an institution where the risk management system does not significantly mitigate the high inherent risk. Where the inherent risk is moderate, a risk management system that has significant weaknesses could result in a high net risk. This could be because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.

b. A moderate net risk would generally be assigned to an institution where the risk management systems generally mitigate the risk. Where there is low inherent risk, weaknesses in the risk management system may result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the institution.

c. A low net risk would generally be assigned to an institution where inherent risk is low. An institution with moderate inherent risk may be
assigned a low net risk where internal controls and risk management systems are strong and effectively mitigate much of the risk.

5) Direction of risk

The direction of risk adds the forward looking perspective to the risk-based supervision approach. In general, the direction of risk is a function of three things:

a. changes in the external environment;
b. changes in the relative size and complexity of an activity (or the initiation of a new activity) within an institution;
c. the current state of management and the related risk management systems.

Risk can be increasing, decreasing or stable.

*Increasing Risk (↑)*

Increasing Risk indicates that, all things being equal, there is an imbalance between the current, or planned activities of an institution, and the underlying risk management systems. Specifically, the institution’s “risk profile” exceeds the ability of its systems to identify, measure, monitor and control or mitigate risk. Unless corrective action is implemented, institutions experiencing increasing risk are exposed to a greater chance of losses that may have a material adverse impact on its financial position.

This imbalance can be caused by several factors such as:

a. changes in the external or competitive environment; e.g., an increasingly competitive environment may cause strategic, or other categories of risk such as credit to increase even if the institution has initiated no internal changes at all.
b. increasing market volatility overall will cause an increase in liquidity and market risk. While existing systems may have been adequate to support operations in a stable environment, they may be inadequate to compensate for the increase in market volatility, and related increase in loss exposures. The examiner should look to external data, such as news reports, industry and market trends, and the activities of institutions within the market to judge whether an institution faces increasing risk.

Increasing risk may also be the result of internal factors, such as a change in management, strategy or business plan. The examiner will typically rely on off-site monitoring and an early warning system to identify increases in risks from internal factors. Situations of increasing risk are typically characterized by numerous instances of key ratios either exceeding or lagging the peer, and
repeated flags in the early warning system. Additional warning signs indicative of increasing risk include:

a. rapid growth in overall asset size, or within a particular asset segment;
b. increasing concentrations of credit or funding sources;
c. unusually large positions in derivative instruments; or,
d. rapid initiation of new business activities.

Risks can also increase from deterioration in the institution’s existing risk management systems. For example, in an effort to cut costs, management leaves the scope of operations unchanged, but reduces the risk management budget by 50 percent. Risk can also increase if management has not implemented a management succession and training plan and is unable to fill vacant key risk management positions with qualified personnel. The on-site examination will be the primary vehicle to assess the adequacy of risk management systems.

**Stable Risk (↔)**

Stable risk implies that the quality of the institution’s risk management systems is sufficient to balance and support the level of risk assumed. Note however, that this does not require a static, unchanging environment. For example, stable risk could be used to describe a situation in which:

a. there have been no new entrants to the market;
b. ownership structures have remained stable;
c. few new products or innovations have been introduced;
d. review of the off-site monitoring reports, as well as the early warning system indicate little or no significant changes in size, concentrations or product mix;
e. strategic plans and supporting budgets have remained the same, with relatively few changes in the staffing or resource levels supporting product lines; or
f. all facets of the supporting risk management systems remain effective, including staffing composition and levels, reporting lines, and support functions such as reporting and MIS.
Conversely, conditions within an institution may have changed. Risk levels may have increased due to heightened competition, the introduction of new products or an expansion of size.

Nevertheless, an institution may still exhibit a stable risk profile if risk management systems have been enhanced to compensate for the increased level of risk. For example, an institution may have implemented a trading activity since the prior examination. By itself, the implementation of this activity increases the risk profile of the institution. However, under further review, examiners find that management has implemented appropriate risk limiting mechanisms, including position limits, real time monitoring and effective separation of the trading desk and back-office function. In this case, the overall risk profile of the institution could still be regarded as stable.

**Decreasing Risk (↓)**

Decreasing risk describes a situation where external factors are becoming less and less influential, or where an institution is streamlining or simplifying operations. For example, an institution that is exposed to fewer, and/or less formidable competitors may be experiencing a decline in inherent risk. Periods of slow economic activity may also correspond to declining inherent risk.

From an internal perspective, an institution can reduce its exposure to risk by eliminating the use of complex strategies, product lines or services. Basically, an institution that concentrates on delivering products and services that are diversified and well understood has a lower risk profile than an institution that deals in exotic products or lacks diversification. Therefore, as an institution moves from complex to simple strategies, product lines or services, inherent risk usually declines.

Finally, inherent risk can also decline if the institution enhances risk management systems with no corresponding increase in its risk profile. For example, the implementation of an effective internal audit function will, all other things remaining unchanged, reduce the level of operational risk in the institution. However, the extent of these enhancements, as well as the corresponding reduction in risk can only be judged through the on-site examination process.

6) Determination of Overall Risk

Once the examiner has determined the net risk for each risk category, an overall risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk
matrix. The overall risk rating is based on the simple average of all net risk ratings. The direction of overall risk is also determined based on the judgment of each individual net risk. Following the development and analysis of the Risk Matrix, the examiner prepares a written risk assessment to serve as an internal supervisory planning tool and to facilitate communication with other supervisors. (The Risk Assessment format is depicted in Appendix III.) The goal is to develop a document that presents a comprehensive, risk focused view of the institution, delineating the areas of supervisory concern and serving as a platform for developing the supervisory plan.

The format and content of the document are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution and, therefore, should consider the institution’s evolving business strategies and be amended as significant changes in the risk profile occur. The risk assessment should include input from other affected supervisors and specialty units in order to ensure that significant risks of the institution are identified. The risk assessment should:

a. Include an overall risk assessment of the organization.

b. Describe the types (credit, market, liquidity, country or transfer, operational), level (high, moderate, low), and direction (increasing, stable, decreasing) of risks.

c. Identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate and the key issues that could affect the risk profile.

d. Consider the relationship between the likelihood of an adverse event and the potential impact on an institution (e.g., the likelihood of a computer system failure may be remote, but the financial impact could be significant).

e. Describe the institution’s risk management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the ability of the institution to appropriately add to and manage its risks.

The examiner should attempt to identify the cause of unfavorable trends, not just report the symptoms. For example, if an institution’s liquidity risk is increasing because of declining core deposits, the reasons for this decline in core deposits should be addressed. By identifying the cause of the decline, the examiner will be able to assess the prospects for a reversal of the decline.

It is important that the risk assessment reflects a thorough analysis leading to conclusions regarding the institution’s risk profile rather than a reiteration of the facts. For example, it is not sufficient to merely report a high loan-to-deposit ratio as a liquidity concern. The examiner should carefully analyze the liability structure to form a judgment about the seriousness of the concern. The significance of a relatively
high loan-to-deposit ratio in an institution whose liabilities are virtually all highly stable core deposits is possibly less of a concern than the same ratio in an institution with a highly volatile liability structure. Liquidity risk might be high in the latter situation and moderate or low in the former, even though the ratio is the same.

3.1.8. Procedures

I. Complete and/or update the Risk Matrix by:

A. Determining the quantity or level of inherent risk in each functional area or activity;
B. Assessing the adequacy of risk management systems to manage risks for each functional area;
C. Determining the functional composite risk profile for each functional area;
D. Determining the aggregate inherent risk rating profile for each inherent risk across the institution;
E. Assessing the adequacy of aggregate risk management systems for each inherent risk across the institution (per risk management system and aggregate basis);
F. Assessing the overall composite risk for each inherent risk across the institution;
G. Determining direction of overall composite risk per inherent risk across the institution; and,
H. Determining the overall inherent risk, overall risk management systems, overall composite risk, and direction of overall composite risk.

II. Complete the written Risk Assessment which should incorporate the following:

A. An overall risk assessment of the bank;
B. The types of inherent risks, their level and direction;
C. The identification of all major functions, business lines, and products from which significant risks emanate;
D. A description of the risk management system;
E. The relationship between the likelihood of an adverse event and its potential impact on the bank;
F. A comment on the consolidated risk management system and the internal and external audit functions.
### 3.1.9. Appendix II: Risk Matrix

#### PROFILI I RREZIKUT TË BANKËS

<table>
<thead>
<tr>
<th>Area of risk</th>
<th>Inherent Risk (low, moderate, high)</th>
<th>Quality of risk Management (weak, acceptable, high)</th>
<th>Overall Risk level (low, moderate, high)</th>
<th>Direction Of risk (increasing↑, stable ↔, decreasing ↓)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OVERALL RISK</strong></td>
<td>High</td>
<td>Weak</td>
<td>High</td>
<td>Increasing ↑</td>
</tr>
<tr>
<td><strong>CREDIT</strong></td>
<td></td>
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<tr>
<td>-lending for legal persons</td>
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<tr>
<td>-individual lending</td>
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<tr>
<td>- commercial lending</td>
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<td>High</td>
<td>Increasing ↑</td>
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<tr>
<td>- real estate</td>
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<tr>
<td>- SME</td>
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<tr>
<td><strong>MARKET</strong></td>
<td>Mesatar</td>
<td>Weak</td>
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<td>Increasing ↑</td>
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<tr>
<td>- Deposit &amp; investment decisions</td>
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<tr>
<td><strong>LIQUIDITY</strong></td>
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<td>Moderate</td>
<td>Increasing ↑</td>
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<td>- deposit &amp; investment decisions</td>
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<td><strong>OPERATIONAL</strong></td>
<td>High</td>
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<td>Increasing ↑</td>
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<td>- individual operations</td>
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<td>- information systems - internal &amp; external audit services</td>
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<td>Moderate</td>
<td>Acceptable</td>
<td>Moderate</td>
<td>Stable ↔</td>
</tr>
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</table>
3.1.10. Appendix III: Risk Assessment Summary Format

- INTERNAL RISK MANAGEMENT SYSTEM
  - Risk Management structure
  - Categories of risks
  - Policies, Procedures and Limits
  - Discussion on risks’ assessment by internal and external auditors or any other independent reviewer.

- OVERALL RISK ASSESSMENT
  - Overall risk rating
  - Trend/Direction of overall risk
  - Supporting narrative comments

- INDIVIDUAL RISK ASSESSMENT
  - Net risk rating
  - Direction of risk
  - Supporting narrative comments

- RECOMMENDATIONS ON ACTION TO BE TAKEN
  - Comment on the need to issue directive or recommendation to the institution based on the outcome of the institution profile assessment
  - Comment on the need for changes to the supervisory plan, if any.

3.2. Step 3 – Planning and Scheduling Supervisory Activities

3.2.1. Objectives

- To provide a bridge between the supervisory concerns with a bank and the activities to be conducted, over time, which will enable the CBK to determine the effectiveness of management of the bank to identify, measure, monitor, and control or mitigate risks within the institution.
3.2.2. **Background**

Bank examiners should develop and maintain a Supervisory Plan (the format for the Supervisory Plan is shown in Appendix IV) that is current and relevant to a bank’s size complexity and changing risk profile. Generally, a supervisory plan may be developed annually and reviewed quarterly to reflect any new risk trends. A supervisory plan provides a bridge between the supervisory concerns identified through risk assessment and the supervisory activities to be conducted. The plan should incorporate a schedule for off-site and on-site activities to be undertaken for the given planning period.

To be effective, planning requires an initial statement of objectives and identification of related strategies for them to be achieved. A good plan should demonstrate that the supervisory concerns identified in the risk matrix and risk assessment narrative as well as the deficiencies noted in the previous examination are being, or will be, addressed.

The Examiner in Charge (EIC) requests information from the institution for the purpose of conducting a preliminary review and preparing the on-site examination scope memorandum. The Scope Memorandum identifies the key objectives and scope of any planned on-site examinations. The First Day Letter identifies the information necessary for the successful execution of the on-site examination, introduces the examiners who will conduct the examination, and is sent to the institution in advance of the examination start date.

3.2.3. **Procedures**

I. Prepare and/or update the Supervisory Plan for the institution to be examined.

   A. Review the most recent Risk Assessment which was developed based on the bank’s most recent Institutional Overview and the most recently completed Risk Matrix.
   B. Review the most recent Report of Examination (ROE) – including the CAMELS rating assessments.
   C. Review any correspondence sent or received since the last on-site examination.
   D. Determine and list the frequency (i.e., monthly, quarterly) and scope of off-site reviews and any issues or concerns identified.
   E. Determine the timing and scope of the next on-site examination. Indicate the proposed number of man-days required to complete the examination.
   F. Determine the timing, scope and staffing needs of subsequent on-site examinations and off-site analyses during the next twelve months.
3.2.4. Appendix IV: Illustrative Format for a Supervisory Plan

<table>
<thead>
<tr>
<th>Banking Institution:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting Date:</td>
</tr>
</tbody>
</table>

**A. Supervisory Concerns:**

Identify supervisory concerns by reviewing the following:

- risk assessment;
- CAMELS assessments;
- other available information (e.g. previous examination findings, internal and external audit reports, liaison with various parties);
- other significant events (e.g. merger, acquisitions)

**B. Supervisory Strategies and Activities to be Conducted:**

Identify strategies to address the supervisory concerns as well as specific activities to be conducted on (Banking Institution, holding company and key non-bank subsidiaries within the group).

1. **Off-site Monitoring**

   **Comments:**

   Provide information on proposed off-site activities, taking into consideration the objectives, scope and specific supervisory concerns.

<table>
<thead>
<tr>
<th>No.</th>
<th>Activity</th>
<th>Objective/Scope</th>
<th>Period</th>
<th>Remarks</th>
</tr>
</thead>
</table>

2. **On-site Examination**

   **Comments:**

   Provide information on proposed on-site examination activities, taking into consideration the objectives, scope, date of last on-site examination and specific supervisory concerns.

<table>
<thead>
<tr>
<th>No.</th>
<th>Activity</th>
<th>Objective/Scope</th>
<th>Period</th>
<th>Remarks</th>
</tr>
</thead>
</table>
3.3. Step 4 – Defining Examination Activities

3.3.1. Objectives

- To identify key objectives and scope of an on-site examination;
- To identify individuals assigned to the examination and their duties during the examination;
- To list deliverables to be developed as a result of the examination.

3.3.2. Background

Examination procedures should be tailored (full-scope or targeted examination) to the characteristics of each institution, keeping in mind its size, complexity and risk profile. The procedures should focus on developing appropriate documentation to adequately assess management’s ability to identify, measure, monitor, and control or mitigate risks. Procedures should be completed to the degree necessary to determine whether the institution’s management understands and adequately monitors and controls or mitigates the types and levels of risks that are assumed.

The scope memorandum (the format for the Scope Memorandum is shown in Appendix V - 1) is an integral product in the risk-based methodology as it identifies
the key objectives and scope of the on-site examination. The focus of on-site examination activities, identified in the scope memorandum, should be oriented to a top-down approach that includes a review of the institution’s internal risk management systems and an appropriate level of transaction testing. The risk-based methodology provides flexibility in the amount of on-site transaction testing. Although the focus of the examination is on the institution’s processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems. If internal systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, then transaction testing must be adjusted to increase the amount of coverage. The scope memorandum should be tailored to the size, complexity and current rating of the institution and should define the objectives of the examination.

The memorandum should generally include:

- a. Scope and objectives of the examination;
- b. Summary of institution’s risk profile and any changes to the institutional overview after incorporating information from preliminary review on-site and off-site information;
- c. Summary of the Pre-examination Meeting;
- d. Summary of Audit Review;
- e. Examination Focus and Procedures;

3.3.3. Procedures

I. Prepare the Scope Memorandum for the next scheduled on-site examination following the format as shown in Appendix V – 2 (Sample – Sample Scope Memorandum for on-site examination).

A. Review the most recent Risk Assessment, Risk Matrix, ROE and CAMELS and CABELs ratings.
B. Review the bank’s Supervisory Plan.

II. Hold a pre-examination meeting with senior management of the bank to discuss the following:

A. Primary target market and business lines, and significant changes in bank products or services including areas of growth;
B. Economic conditions within the target markets and any other external factors affecting the primary business lines;
C. Areas representing the greatest risk to the bank and/or markets;
D. Changes in bank management, key personnel or operations since previous examination;
E. Results of internal and external audits and internal controls review, including any follow-up required by management;
F. Any material changes to internal or external audit’s schedules or scope and adequacy of audit staffing;
G. Corporate considerations (i.e., proposed or recently completed purchases, acquisitions, mergers or divestiture considerations);
H. Changes in technology including operational systems, technology vendors/service providers, critical software, internet banking, or plans for new products/activities that involve new technology since the previous examination;
I. Issues regarding compliance with laws, regulations and rules governing banking business;
J. Other issues that may affect the risk profile;

Management concerns about the bank or CBK’s supervision including any areas the bank would like the CBK to consider in the examination scope with reasons for inclusion.

III. Prepare First Day Letter (Entry Letter) as defined in Appendix VI (Samples of First Day Letter).

A. To eliminate duplication and minimize the regulatory burden on an institution, the letter should not request information that is provided on a regular basis to, or is available within, the CBK, such as regulatory reports and other various financial information.

B. Items that are not needed to support selected examination procedures should not be requested;

C. Distinguish information to be mailed to the EIC for preliminary review to be conducted off-site from information to be held at the bank for on-site review. Information that is not easily reproduced should be reviewed on-site (e.g. policies, BOD meeting minutes). Information may be presented electronically or in paper form.

D. Present letter to management of the bank at least 10 workdays prior to arrival of the on-site examiners.

3.3.4. Appendix V – 1: Scope Memorandum Format for On-Site Examinations

1) SUMMARY OF THE BANK’S SITUATION
2) SCOPE AND OBJECTIVES
   • Specification of the type of examination (complete/focused) and supporting reasons for the type of examinations;
   • Objectives of the examination.
3) SUMMARY OF INSTITUTION’S PROFILE

- Financial condition (with the latest data);
- Risk assessment;
- Issues of concern.

4) SUMMARY OF THE PRE-EXAMINATION MEETING

5) SUMMARY OF AUDIT AND INTERNAL RISK MANAGEMENT SYSTEM

- Determine the adequacy of the external and internal audit function and internal risk management system in order to set the level of reliability.

6) EXAMINATION FOCUS AND PROCEDURES

- Areas of concentration during examination.

7) RESOURCE PLANNING (OF STAFF)

3.3.5. Appendix V – 2: Sample (example) of scope memo for on-site examinations

<table>
<thead>
<tr>
<th>SCOPE MEMORANDUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of the bank</td>
</tr>
<tr>
<td>Type of examination:</td>
</tr>
<tr>
<td>Last date of examination:</td>
</tr>
<tr>
<td>Date of commencing examination:</td>
</tr>
<tr>
<td>Financial data up to:</td>
</tr>
<tr>
<td>Planning the workdays:</td>
</tr>
</tbody>
</table>

1) Summary of the bank’s situation:

Specification of the overall financial situation of the bank including the main financial indicators characterizing the bank. Also, comparisons with the banking sector in its main parameters, as well as towards the parent bank is necessary.
2) Scope and objectives:

- Determination of the financial situation and assessment of the bank's financial performance by risks;
- Assessment of the bank's compliance with the legislation in force with special emphasis on reporting requirements as well as legal and regulatory indicators;
- To review of the areas of expansion such as new branches and new lines of business as well as processes for managing associated risks.

3) Summary of risk profile:

- Financial Condition
  On the date xx xxxx xxxxx, the xxx bank had overall assessment of x, due to the failure of the bank to meet the regulatory requirements of capital adequacy. The base capital ratio (total capital) to total risk weighted assets was x%, which is below the regulatory requirement of xx%. Asset quality is satisfactory despite the fact that the level of non-performing loans is growing. Liquidity and earnings are estimated to be satisfactory.

- Risk Assessment
  The overall risk assessment of xxx bank was moderate considering the high credit and operational risk. Credit risk is high due to poor management by the board of directors and senior management in the process of granting and administering loans, whereas operational risk is high due to the lack of policies and procedures for external operations and for human resource management.

  Inadequate internal controls also contributed to high operational risk. Liquidity risk is moderate but it is growing due to the bank's dependence on volatile deposits. Interest rate risk is low whereas the risk of foreign exchange rate is moderate, but growing.

- Issues of Concern
  Concerns can include high staff turnover, growth in lending to the agricultural sector, new branches, plans to establish a leasing unit or acquisition of a bank.
### Risk profile of xxxxx bank on the date day-month-year

<table>
<thead>
<tr>
<th>Risk category</th>
<th>Amount of inherent risk</th>
<th>Risk management quality</th>
<th>Overall risk level</th>
<th>Direction of the risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall risk</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
</tr>
<tr>
<td>Credit risk</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
</tr>
<tr>
<td>Market risk</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
</tr>
<tr>
<td>Operational risk</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
<td>xxx</td>
</tr>
</tbody>
</table>

---

4) **Summary of Pre-Examination Meeting:**

Management is aware of its plan to examine xxxx bank, one of the largest banks in Kosovo with branches throughout the country. It is estimated that the bank is (not) aware of the risks associated with it. Also, it was discussed about the weaknesses found in the field of lending where the bank has informed the CBK that they are working on them. Regarding the increase in lending to the agricultural sector, the bank should understand the risks involved, however, there is no adequate system to manage these risks and expertise of lenders in this sector is unknown. The bank is also aware of the high staff turnout and is currently in the process of drafting policies for managing human resources, which will include a staff retention scheme.

5) **Summary of Audit and Internal Risk Management System:**

Audit is adequately performed, however, management does not respond to issues raised in the audit reports. Internal risk management systems are considered to be inadequate due to weak BOD and senior management oversight in credit and operational risks. Internal control system is inadequate as indicated by the lack of important policies such as foreign exchange policies and lack of segregation of duties in the cash management section. Due to these weaknesses, reliance on internal risk management systems will be minimal.

6) **Examination Focus and Procedures:**

Summarized below are the examination focus and procedures to be applied:

**Credit Risk.** As credit risk is rated high and is on an increasing trend, standard assessment procedures (as discussed in the individual risk sections later in this manual) and expanded procedures (if necessary), will be applied. Examiners will primarily focus on:
• Recent increase in non-performing assets;
• Growth in lending to agricultural sector and lender qualifications regarding this sector;
• Single borrower's limits and possible concentrations;
• Loan documentation;
• Credit review;
• Credit granting procedures.

**Operational Risk.** Operational Risk is rated high with an increasing trend. Due to this, standard procedures (if necessary) will be used in assessing the quantity and quality of the risk management function. Main areas of focus will be:

• Expansion of branch network;
• Weak internal control system especially on the cash management section;
• Lack of foreign exchange and human resource policies and inadequate IT policies.

**Liquidity Risk.** Since liquidity risk is rated low with an increasing trend, standard core procedures may be applied with attention being paid on the institution’s dependence on volatile deposits.

**Foreign Exchange Risk.** Foreign exchange risk is considered to be moderate and is increasing. Standard Assessment procedures should be applied. An examiner reviewing this area should bear in mind that the institution lacks a foreign exchange operations policy to guide the foreign exchange operations and hence there might be a need to apply expanded procedures to thoroughly assess the quality of risk management systems, if present.

**Interest Rate Risk.** Since the interest rate risk is estimated low and is stable, minimum procedures shall be used to confirm the risk level and risk management quality. Standard procedures may be applied if an examiner establishes that there is a concern warranting expanding the assessment.

**Capital Adequacy.** Since the institution’s capital is below the regulatory capital requirements, standard procedures may be applied to assess the level of capital and establish reasons for the institution’s failure to meet the regulatory requirement.

**Earnings.** Earnings performance is marginal. Income from lending continued to be the major source of income. Standard procedures may be applied with the focus on evaluating the effect of an increase in non-performing loans and the opening of new branches which might have increased operating expenses.

**Strategic planning.** Strategic plan of xxx bank should be correlated with its
actions i.e. the planned increase of loans during xxxx should be consistent with the risk appetite of the board of directors as well as the experience and expertise of management. Examination will be focused on:

- Assessment of budgeting processes and assumptions used to draft the budget and strategic plan;
- Assessment of the plan for growth in relation to the current growth and the number of necessary staff to maintain and manage the growth.

**CAMELS components and risk assessment.** Preliminary examination, conducted on xx xxxx xxxx, has resulted in CAMELS assessment xxxxxxx/x. Overall bank risk profile is assessed as satisfactory and has improved compared to the previous examination. The bank’s capital levels are good, continue to be on the border with minimum risk weighted capital. Asset quality and credit management practices are assessed as good. Classified and non-performing loans have marked deterioration and have marked an upward trend compared to the previous examination. Bank earnings must improve, despite the positive earnings trend, due to accumulated losses from previous years. Levels of bank liquidity and liquidity management practices are good. The practice of market risk management should be improved. The overall operational risk is high. The bank was ordered to provide adequate policy for managing the operational risk, to establish a committee for managing the operational risk and to determine main risk indicators.

**Procedure of examination.** Depending on the risk level are specified examination procedures, minimum or standard.

7) **Resource planning (of staff):**

In view of the areas to be focused during the examination, it is estimated that six examiners will be needed. The examination is expected to take ten days. Other required resources include stationery, lap tops and transport.
Below is given an example of resource planning.

<table>
<thead>
<tr>
<th>ACTIVITIES</th>
<th>Responsibl persons</th>
<th>Days available</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>PERIOD PRIOR EXAMINATION</td>
<td>RE HD DD</td>
<td>17 3 2</td>
<td>22</td>
</tr>
<tr>
<td>EXAMINATION OF MANAGEMENT</td>
<td>RE HD DD</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

Assessment of management and strategic plan: Minimum procedures with additional time for complete review of CMS and other procedures related to risk.

| Capital: Minimum procedures                     | RE HD DD           | 20 20 20       | 140   |
| Revenues: Minimum procedures                    | RE HD DD           | 10 0           | 10    |
| Credit risk: Standard procedure to provide time to review the large loans; new loans (focus on the written standards and monitoring processes); past-due and non-performing loans; collection of bad loans; and effectiveness of credit risk management. | RE HD DD | 1 4 2 | 17 |
| Liquidity risk: Standard procedures             | RE HD DD           | 10 0           | 10    |
| Market risk: Minimum procedures                 | RE HD DD           | 10 0           | 14    |
| Operational risk: Standard procedures to assess controls, staff, IT system, and overall effectiveness of CMS | RE HD DD | 1 1 1 | 25 |
| IT: Standard procedures                         | RE HD DD           | 15 1           | 15    |
| Function of auditing and internal controls: Standard procedures | RE HD DD | 15 15 15 | 30 |
| Control of the work papers and filing the examination documents | RE HD DD | 1 3 9 | 32 |
| Examination report and the meeting with board of directors: Draft the report and discuss findings Review the Draft Report: | RE HD DD | 10 5 2 | 17 |
| Other: Follow-up on the commitments of the management with regard to issues or recommendations in the previous report of examination | RE HD DD | 4 | 4 |
| Total                                           |                    | 379            | 379   |

<table>
<thead>
<tr>
<th>Budget (from Risk Profile)</th>
<th>379</th>
<th>Summary of workdays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realization</td>
<td>RE; HD; DD</td>
<td>1</td>
</tr>
<tr>
<td>Difference:</td>
<td>379 Senior (S)</td>
<td>3</td>
</tr>
<tr>
<td>Rationale: Workdays are expected to have higher volume than the previous examinations due to the implementation of RBS and training requirements for staff</td>
<td>E;ER;IT</td>
<td>9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>DD</td>
<td>Director of Department for bank supervision</td>
</tr>
<tr>
<td>HD</td>
<td>Head of division</td>
</tr>
<tr>
<td>RE</td>
<td>Responsible examiner</td>
</tr>
<tr>
<td>S</td>
<td>Senior bank examiner</td>
</tr>
<tr>
<td>E</td>
<td>Bank Examiner</td>
</tr>
<tr>
<td>IT</td>
<td>Bank Examiner for Information Technology</td>
</tr>
<tr>
<td>NE</td>
<td>New Bank Examiner</td>
</tr>
</tbody>
</table>
3.3.6. Appendix VI: A sample information letter and request letter are presented below:

Day month year

Mr./Mrs. Xxxxx Xxxxxx
Chief Executive Officer
Name of the bank
Street “xxxxxxx”, no. xx
xxxxxxx, Kosovo

Subject: Commencement of examination of xxxx in xxx bank

Dear Mr./Mrs. xxxxx;

In accordance with Article 57 of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-bank Financial Institutions, the Central Bank of Republic of Kosovo (CBK), it will be performed the complete examination, in xxxx bank starting from the date xx xxxxxx xxxx, and by using financial information of the date xx xxxxxx xxxx, unless otherwise required.

Required information in the appendix attached to the request letter, should be available in soft or hard copy, according to the dates specified in Appendix. In order to enable us to complete the examination in time, please provide us with general information as specified in Part I and all policies and procedures on the first day of examination. Unless is specified another date in the request letter, the requested information must be provided (to be ready) no later than the date xx xxxxxx xxxx.

Please note that during the examination, examiners may request explanation, clarification or additional information before, during and after the examination. CBK appreciates your cooperation. If deemed necessary, additional information may be required by us for the purpose of completing the examination.

Please classify all required documents in such a way that they correspond to the numbers specified in this request letter.
The examination will be carried out by a team of xx examiners, headed by Mr./Mrs. Xxxxx XXXXXXX, responsible examiners for xxxx bank. To clarify about any required information, do not hesitate to contact Mr./Mrs. XxxxxXXX through telephone number xxx / xxx-xxx or via email: Xxxxx.Xxxxxx@bqk-kos.org.

We plan to hold the introductory meeting with the upper management of xxxx bank on the date xx xxxxxxx xxxx, at 10:00 to discuss the bank's risk profile and the scope of our examination. Participants from CBK will be the Director of Banking Supervision Department (Mr. Xxxxx XXXXXX), Head of the Division of On-site Supervision (Mr. Xxxxx XXXXXXXXXX) and Responsible Examiner (Mr./Mrs. Xxxxx XXXXXXX). Also, during the examination we plan to have additional meetings with upper management in order to keep you informed about the examination. We will set a Concluding meeting to inform you on our conclusions and findings during examination.

The examination will be focused on the field of credit risk, operational risk (including information technology), internal audit, internal controls, risk liquidity, sensitivity to market risk, as well as assessment of capital and profits.

At the conclusion of the examination, we would appreciate your comments regarding the process after completion of the examination.

Sincerely,

Xxxxxx XXXXX
Director
Banking Supervision Department
REQUEST LETTER FOR EXAMINATION INFORMATION

I. General information - please have ready on the day of arrival of the CBK examiners, the following information:
   1. Annual reports of xxxx bank and of parent bank.
   2. The strategic plan of the bank.
   3. The organizational structure of the bank.
   4. A list of the members of the board of directors, senior managers, board and management committees, with the list of committee members (please note committee members and chairs of committees, including: name, position, years in the bank or in board or in any other activity outside the bank).
   5. Minutes of the board of directors and all committees’ meetings since the latest examination (xx xxxxxx xxxx).
   6. Minutes from the annual meetings of shareholders, or some extraordinary meeting of shareholders since the latest examination (xx xxxxxx xxxx).

II. Credit risk (credit portfolio) – please have the following information ready as stated in points 7 to 10, on the date of arrival of CBK examiners:
   7. Copies of all updated credit policies and procedures, including internal policies on reviewing the loans and collateral assessment policies.
   8. Copies of the limits of the bank officials and the credit committees.
   9. The management and / or board of directors reports on findings regarding violations of the law, credit limits and the related parties credits, with details on how they have improved or will improve in the future.
   10. Minutes of all meetings of committees on issues related to credit risk management or granting loans, or any presentation or discussion related to the risk tolerance or acceptance of bank risk.
   11. Send the list of loan portfolios on the date xx xxxxxxx xxxx. The list should be divided into columns with the following information: name of the borrower, the amount of loans allowed at the time of disbursement, the disbursement date, maturity date, interest rate, type of loan, the amount in use, the status of the loan classification, the rescheduled loans, bank personnel loans, the amount of provision, the provision percentage, the number of loans overdue, industry sector and information on the collateral and / or guarantor.
   12. Changes of staff assigned in granting loans, loan products, internal grading system and management of loan portfolio.
   13. Copies of reports of internal loan revision and dates of revising the completed loans since the latest examination (xx xxxxxxx xxxx).
   14. List of rescheduled loans.
   15. Copies of the reports of loans concentration since the latest examination (xx xxxxxxx xxxx). The report must contain concentration by borrower, industry sector, geographic region, type of loan and by any other area identified by the bank for the purpose of monitoring.
16. Copies of internal reports of portfolio management (including portfolio analysis reports detailing the level and trend in loans in arrears and losses, as well as the trend in the restructured and renewed loans, policy exemptions, exemptions from the credit administration documentation, updated financial statements of the borrower, and collateral exceptions list or list of lack or expiration of collateral insurance, etc.).

17. Reports on the allocation of the loan portfolio based on sectors (trade, agriculture, hospitality, etc.) and based on categories (corporate, small and medium enterprises, etc.). The report should include total sum and provisions for each category.

18. Reports on loans that exceed 10% of Tier 1 capital, as defined in the CBK Regulation on Large Exposures.

19. List of non-accrual loans (name, amount, overdue days, the maturity date, the date the loan became non-accrual) and provision amounts related to them.

20. The list of rescheduled loan products including overdue days prior to rescheduling the loan.

21. List of loans written off or recovered since the latest examination (xx xxxxxxx xxxx).

22. List of loans to insiders, including related parties and their interests. (name, officer/director/shareholder, the actual amount of exposure, the amount allowed and the maturity date).

23. List of off-balance-sheet items (guarantees, letters of credit, name, amount, date of allowance, classification status, date of maturity and collateral).

24. List of loans written off and the related collateral, which are still in the bank's books as an asset (the name of the borrower, the value in books, the exclusion date and collateral assessment date).

25. Reconciliation of provisions account for loan losses.

26. Any other information related to the risk characteristics of the credit portfolio, such as economic indicators, industry trends and new products planned or already launched in the market.

27. Copies of any other credit management report, previously unidentified, which can help our review of credit risk management and asset quality.

**Investment and securities portfolio**

28. Policies and procedures for investments and securities and dates of their approval by the board of directors. Including limits of approved investment (type, classification, maturity). Also provide bank exemptions report.

29. The list of placements with other banks, receivable interbank loans, trade bills, investments in securities and other assets accounts with material balances (e.g., > 5% of total assets).

30. List of all funds invested abroad.

31. List of investment accounts, including: the amount, currency, interest rate, date of start and maturity, and financial institution rating (assessment).
Also provide a copy of the confirmation from correspondent banks with the last 3 accounting equalizations.

32. Provide a copy of the latest report of the analysis of the investment portfolio, including management recommendations regarding potential purchases and sales.

III. Liquidity Risk

33. On the date xx xxxxxxx xxxx, send copies of all policies and procedures of liquidity and asset management—liabilities, with dates when they were updated and approved by the board of directors since the latest examination (xx xxxxxxx xxxx).

34. Provide a copy of the policy and funding plan for liquidity needs in extraordinary conditions of the bank.

35. Provide copies of stress-test of liquidity conducted by the bank.

36. Provide minutes of meetings of the committee for management of assets and liabilities (ALCO) or any other committee on the management of liquidity since the latest examination (xx xxxxxxx xxxx).

37. Provide a copy of the bank’s liquidity report, including the most recent reports of the maturity gaps and structure of deposits by type and maturity.

38. Provide details regarding changes in: liquidity risk management, liquidity planning or funding sources and needs, investment strategy and policy of the bank’s liquidity or plan of the fund for emergency needs of the bank, since the latest examination (xx xxxxxxx xxxx).

39. Provide management reports used to measure and monitor current and expected needs for liquidity.

40. Policies and procedures relating to any financial derivatives activity and management reports related to these activities.

41. List of 20 largest depositors of the bank (name, type of account, balance, maturity and interest rate).

42. The current structure of interest rates on deposits and loans.

43. Copies of policies and procedures for market risk management.

44. All management reports related to market risk management.

IV. Operational Risk

45. Policies and procedures for managing operational risk.

46. Minutes of committee meetings for operational risk since the latest examination (xx xxxxxxx xxxx).

47. Provide a list of the staff responsible for operational risk, their CVs and their responsibilities.

48. All management reports related to operational risk management (reports of exceptions, information technology issues, lack of cash or equipment, etc.).

49. Summary of the bank insurance policies including: the type of insurance policy (property, bank activity stoppages, protection of directors,
equipment, vehicles, overstepping responsibilities, fraud, additional policies).

50. Copies of reports of security officials that present any complaints submitted since the latest examination (xx xxxxxx xxxx). Note if these reports were presented to the board of directors.

51. The list of employees who have left the bank (resigned or dismissed) since the latest examination (xx xxxxxx xxxx) including: name and surname, position, branch or office, date of commencement of work, date of dismissal or resignation and the reasons for quitting the job.

52. Provide copies of any formal process (or informal) of operational risk management and strategy (program) of implementation.

53. If models are used, provide information on how the operational risk manager assesses models, frequency of assessment of models and independence of the validity of the model.

54. List all bank products and policies for approval of new products.

55. If the bank transfers or delegates any of its activities or information technology to external parties, obtain copies of the bank's program regarding management of the process of delegation or transfer, also the policies, procedures, contracts and management report prior to management signs with service provider.

56. Provide information regarding organizational changes (including acquisitions and mergers), changes in the profile and strategy, changes in the provided products and services, information technology systems, etc.

57. Provide reports or other information regarding: compliance with internal policies and procedures, legal and regulatory requirements, results of security tests of information technology of the institution and the response of management, results of tests of the emergency plan and the response of management, as well as recent reports of information system management related to fraud, business stoppages, system failures and losses during the proceedings.

58. Provide a copy of the operational risk profile of the bank, which has been presented to the board of directors.

59. Provide information on the processes of banks related to collecting operational losses data.

**Information Technology**

60. On the date xx xxxxxx xxxx, submit the policies and procedures for information technology and information security.

61. On the date xx xxxxxx xxxx, submit the policies and plans for business continuity and results of tests carried out during the last two years.

62. The list of incidents since the latest examination (xx xxxxxx xxxx) including the number and volume of operational losses, system failures, the number of hackings in the automated bank systems, the fraudulent actions of staff and changes of staff (in particular changes of key staff).

63. A report or a list of shortcomings identified by the auditors regarding the functioning of systems that significantly increase the risk of the bank.
64. The organizational structure and job description for information technology staff.

65. Reports of the information technology department to bank management.

66. A list and description of the information technology applications used by the bank. Location of the main database of applications and the location of support staff/helpdesk. Specify which ones are developed by the bank and which ones are purchased and from what company.

67. Procedures for controlling the placement/change of the access rights of user in applications, database and network for all applications used in the bank.

68. Reports of management to the department of information technology.

69. The strategy of the bank in the field of information technology.

70. Internal audit reports of information technology.

71. A list of active workers and their access to the bank systems.

72. List of external persons / companies regarding information technology and bank systems that they support.

V. Risk Management

73. Copies of the budget of the bank for the last two years.

74. A list of all policies approved by the board of directors, date of the approval and the date of latest review or correction.

75. Details regarding methods of communication used to inform staff on the changes in policies and / or procedures of the bank.

76. Summary of all court proceedings against the bank since the latest examination of the bank (xx xxxxxx xxxx).

VI. Capital

77. The list of shareholders that own 5% or more of the overall capital of the banks, including: name of the shareholder, number of shares owned overall capital percentage and type of shares in their possession (e.g. usual, preferential etc).

78. Reports used by the management to monitor and design capital requests that ensure the accuracy of weighted risk used for the supervision of capital calculations.

79. Provide written information for the internal process of assessing capital adequacy.
80. Provide reports or minutes of the board of directors indicating the boards and management approach with regard to risk capital.

VII. Profits

81. Ensure the latest copy of the management report in order to compare the budget with the current situation, changes included and the explanations of the changes.

82. Management reports on the income trend together with management explanations.

85. Policies and procedures for termination of calculation of interest for non-performing loans.

86. Balance sheet and income statement detailed by date xx xxxxxxx xxxx.

87. Obtain the most recent report of management on revenues, including graphs, tables and indicators.

VIII. Auditing and internal controls

88. On xx xxxxxxx xxxx, submit the code of ethics of the bank, policies of internal audit and internal controls and internal audit charter stating the purpose, objectives, organization, authority and responsibility of the Internal Audit Department.

89. On xx xxxxxxx xxxx, submit the plan of internal audit which addresses the objective, schedule, budget of the staff, reporting, financial budget and schedule for audit during the last two years.

90. Provide a detailed list of duties and responsibilities of internal auditors.

91. Provide manual of procedures of the audit department regarding the audit work program; if applicable, risk-based audit / risk assessment.

92. Ensure all audit reports prepared since the last examination (xx xxxxxxx xxxx).

93. Provide, listed, all audit findings, pending settlement, outstanding; including time and plan for the implementation of corrective measures.

94. Ensure minutes of meetings of the Audit Committee since the last examination (xx xxxxxxx xxxx).

95. Provide list of staff of the Audit Department, including the head of the audit, including their CVs. Details of duration of employment of audit staff, staff turnover, and provide description of duties or position.

96. Provide information regarding the bank's program for professional development and training of audit staff, including guidance on training opportunities within and outside the institution. Provide a list of all audit
staff with training followed or hold since last examination (xx xxxxxx xxxx).

97. Provide a letter of engagement of the external audit, report and letter of management for the last and next to last year. Provide a letter of engagement for the current year.

98. Provide any contracts for external activities (outsource) as well as external reports or (due diligence) of external parties (outsourced contractors).

99. Information on operating losses incurred since the last examination (xx xxxxxx xxxx).

100. Provide copies of responses of the management on the shortcomings noted in the audit reports.

101. If the bank has a quality assurance program, please provide a standard and criteria that is set to assess the performance of internal audit functions. Provide a quality assurance review that was carried out since the last examination (xx xxxxxx xxxx).

IX. **Finance and accounting**

102. Provide accounting policies.

103. Provide a copy of the general ledger and analytics for all CBK reporting forms, reported on date xx xxxxxx xxxx.

104. Provide list of all branches and sub-branches, including the name, address, name of branch or sub-branch manager, number of staff in each location.

X. **Interest rate risk and market risk**

105. Provide copies of the latest interest rate risk reports, including ALCO reports.

106. Provide an analysis performed by the bank in terms of historical trends and information on clients to assist the management to establish and assess customer behaviour assumptions regarding prepayment of loans and deposit withdrawals.

107. Provide information on interest rates scenarios used by banks to measure the potential for exposure to interest rate risk and frequency of review.

XI. **Other information**

108. Provide two computers with access to the bank system, with codes and passwords for "read only" access in the bank's main systems. The bank's computers should also be linked to the printers.
109. Provide a list of all bank staff with their e-mail addresses and telephone numbers.

3.4. Step 5 – On-site examinations

3.4.1. Objectives

- To determine and validate the financial condition and risk profile of an institution;
- To identify areas in need of corrective actions;
- To recommend appropriate corrective actions;
- To assess on-going activities of the institution.

3.4.2. Background

On-site examinations are part of the continuous process of supervision. They consist of a set of integrated and tailored examination procedures. These procedures are designed to:

- assist the examination team in determining the condition and risk profile of a bank;
- identify areas in need of corrective actions;
- monitor on-going activities of the bank.

Because institution specific risk profiles of banks are diverse, the CBK recognizes that effective and efficient supervision cannot be accomplished using a rigid set of examination procedures.

Examiners, based on the risk profile of an institution, use either minimum scope assessment procedures, standard scope assessment procedures, or a combination of the two to tailor the examination activities to ensure that risks within an institution are appropriately identified, measured, monitored and controlled or mitigated by bank management.

3.4.3. Minimum Scope Assessment Procedures

Examiners will use the minimum scope assessment procedures for reviews in low-risk areas to determine whether any significant changes have occurred in activities, the risk profile, management, or the financial condition of the bank. If no changes in the bank’s risk profile are identified, no further work will be done. However, if the
assessment identifies areas of supervisory concern, the examination EIC has the flexibility to expand the scope of the examination by completing other procedures from the standard scope assessment procedures.

3.4.4. **Standard Scope Assessment Procedures**

Examiners will use the standard scope assessment procedures for reviews of areas of significant activities with high inherent risk. The selected procedures from the standard scope assessment procedures to be completed should be consistent with the bank’s complexity and the level of supervisory concern. While procedures in the standard scope assessment contain detailed procedures or clarifying steps, examiners typically will not need to carry out every procedure.

The approach to on-site examinations should stress the importance of determining and validating the bank’s condition during the supervisory cycle. Generally, during on-site activities, examiners focus on identifying the root cause of deficiencies and ensuring that management is taking appropriate and timely steps to address and correct all deficiencies and prevent their recurrence.

3.4.5. **CAMELS Rating System**

Both sets of assessment procedures cover the review of all the CAMELS rating components, the audit function and internal controls, and all the identified risks namely: credit, market, liquidity, operational, country / transfer risks. “CAMELS” is an acronym for Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk.

The rating system provides a general framework for evaluating and assimilating all significant financial, operational, and compliance factors in order to assign a summary, or composite, supervisory rating to each banking institution. The purpose of the rating system is to reflect in a comprehensive and uniform fashion a bank’s condition, compliance with laws and regulations, and overall soundness.

Although it is acknowledged that to some degree each type of bank poses its own set of supervisory issues and concerns, the uniform rating system is predicated upon certain features and functions, including qualitative and quantitative factors, common to all categories of institutions.

Examiners will assign a rating to each of the CAMELS components for the bank using a scale of 1 to 5, with 1 representing the strongest level of performance, adequate risk management practices and the least degree of supervisory concern,
while the rating of 5 indicates the weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

The ratings for the six individual CAMELS components are summarized in an assigned composite rating which is similarly rated on a scale of 1 to 5. In assigning a composite rating, all relevant factors must be weighed and evaluated. In general, these factors include: (i) the adequacy of the capital base, net worth and reserves for supporting present operations and future growth plans; (ii) the quality of loans, investments and other assets; (iii) the ability to generate earnings to maintain public confidence, cover losses and provide adequate security and return to depositors; (iv) the ability to manage liquidity and funding; (v) the ability to meet the community’s legitimate needs for financial services and cover all maturing deposit obligations; (vi) the ability of management to properly administer all aspects of financial business and plan for future needs and changing circumstances.

The assessment of management and administration includes the quality of internal controls, operating procedures and all lending, investment and operating policies; compliance with relevant laws and regulations; and, the involvement of the directors, shareholders and officials. In general, assignment of a composite rating may incorporate any other factors that bear significantly on the risk management practices and the overall condition and soundness of the institution.

The CAMELS rating system serves as a useful vehicle for identifying problems or deteriorating conditions as well as for categorizing the deficiencies in particular component areas. Further, the rating system assists the CBK in monitoring safety and soundness trends and in assessing the aggregate strength and soundness of the banking sector.

When assigning CAMELS ratings, the examiners should endeavour to ensure that all banks are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the banks exhibiting financial and operational weaknesses or adverse trends. Evaluations of the components should also take into consideration the bank’s size, sophistication, nature and complexity of activities, and its risk profile.

3.4.6. Procedures

Due to the importance the procedures have in this stage, they are presented separately by specifying each minimum and standard procedure. It commenced from the procedures related to the planning and management of the examination and up to the consolidated supervision.
A. PLANNING AND EXAMINATION MANAGEMENT

1. Determine the examination procedures to be performed based on the risk assessment and rating of the bank as summarised in the risk matrix. Ensure the correct scope and assessment procedures are performed based on the risk rating:

<table>
<thead>
<tr>
<th>Low Risk Rating</th>
<th>Moderate Risk Rating</th>
<th>High Risk Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perform Minimum scope core assessment</td>
<td>Perform Standard scope core assessment</td>
<td>Perform Standard scope core assessment plus additional procedures to include more transaction testing</td>
</tr>
<tr>
<td>Implementation of minimum procedures</td>
<td>Implementation of standard procedures</td>
<td></td>
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</tbody>
</table>

2. Perform the appropriate examinations procedures in the assigned areas of supervisory concern.

3. Document, in working papers (sample of working papers is shown in Appendix VII), the work done covering the following areas:

   a) The scope assessment objectives;
   b) Summary of procedures performed to address the core assessment objectives;
   c) The findings and conclusions for the area under review;
   d) Proposed corrective actions, as appropriate.

4. Submit the working papers for review to, and discuss your examination findings and conclusions in the assigned area with, the EIC to ensure that findings are accurate, supported and well documented.

5. Together with the EIC, discuss and agree upon your examination findings and conclusions, with the bank’s management responsible for the assigned area.

6. Provide the examination findings and conclusions that relate to, and are relevant to other areas of supervisory concerns to other examiners assigned the appropriate areas.

7. In consultation with the EIC, assign the appropriate CAMELS rating and appropriate risk rating, for the assigned area.
8. As appropriate, prepare comments for inclusion in the ROE.

9. EIC will consolidate the comments from other examiners on the team into one draft report of examination. The report of examination will:
   a) Define the objectives and focus of the examination;
   b) State the conclusions of the examination;
   c) Identify any significant problems, appropriate corrective actions, and timeframes for corrective actions.

10. The EIC conducts an exit meeting with management of the bank to discuss and obtain agreement regarding the examination findings and conclusions. During the exit meeting, the EIC obtains management’s commitments to implement the recommended corrective actions.

Appendix VII: Working papers

<table>
<thead>
<tr>
<th>Reference of the file of working papers:</th>
<th>E.g.: CAPITAL: (C)</th>
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<tbody>
<tr>
<td>Name and surname of examiner and signature:</td>
<td></td>
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<tr>
<td>Date of completion:</td>
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<tr>
<td><strong>Reviewed by:</strong></td>
<td></td>
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<tr>
<td>Name, surname and signature:</td>
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<tr>
<td>Date of review:</td>
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</tbody>
</table>

| Name of the bank: | XXXXXX |
| Financial information for the date: | xx-xx-xxxx |

<table>
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<th>CAPITAL (C)</th>
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</table>
B. ASSET QUALITY AND CREDIT RISK EXAMINATION

1. Description

1.1. Reach a final, overall conclusion for quality of assets; level of credit risk; and direction of credit risk using the following:
   a) Asset quality rating (1, 2, 3, 4, or 5);
   b) Credit Risk rating (Low, Moderate, or High);
   c) Direction of Credit Risk (Decreasing, Stable or Increasing).

1.2. Complete this section’s objectives to assign the asset quality and credit risk ratings. In assigning the ratings, examiner should consult with the EIC and other appropriate examiners. Examiners should take into consideration rating factors outlined in the CAMELS Rating Guidelines.

2. Assessment procedures

2.1. Minimum scope assessment

Objective

Determine the asset quality component rating, existence of any credit concentrations, the adequacy of the allowance for loan and lease losses (ALLL), the quantity of credit risk, the quality of credit risk management and any violations of law, rulings or regulation (i.e., lending limits, insider transactions, etc.).

Procedures

1. At the beginning of the examination, hold discussions with management covering actual or planned:
   a. Changes in the lending policies and loan administration;
   b. Changes in the lending area’s management or staff;
   c. Changes in loan products, marketing and loan growth;
   d. Changes in the loan review or loan grading system; and,
   e. Other changes in external or internal factors that could affect loan quality.

2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any issues in this area that require follow-up.
3. Obtain asset quality and credit risk-related information from the examiner assigned to review BOD meeting minutes. In addition, review the credit committee minutes to understand the bank’s lending practices.

4. Discuss with the examiner responsible for completing the “Audit and Internal Control” section of the core assessment whether there are any significant audit findings in the credit area that require follow-up, or whether a review of audit work papers is required.

5. If not previously provided, obtain and review the following information and documents, as appropriate:

   a. Credit Policy and Procedures and any changes made since the last examination;
   b. Composition and quality of total assets;
   c. The most recent loan review reports by the bank’s internal credit review staff;
   d. List of renewed or restructured credit facilities;
   e. Past-due and non-performing assets reports;
   f. Internal credit scoring or loan grading reports;
   g. Problem and “watch” loan lists;
   h. List of loans to insiders, including employees;
   i. Concentration of credit reports;
   j. The detail of any “other asset” accounts that are material to the financial statements;
   k. List of off-balance sheet items;
   l. Any other report that may be useful for the review of this area.

6. Review an appropriate sample of loans. The sample should generally include:

   a. Newly advanced credits, including on and off balance sheet loan commitments.
   b. Insider loans;
   c. Large loans (10% or more of core capital);
   d. Past-due and non-performing loans;
   e. Previously criticized loans and loans from the bank’s problem and “watch” loan lists; and,
   f. Representative sample of standard or “pass” loans using accepted statistical sampling techniques.

The size of the sample should be based on the trends and overall risk posed by those segments of the loan portfolio and should at least cover 40% of the portfolio. The purpose of the review is to determine whether the loans show any changes in the bank’s risk selection, the bank’s underwriting practices, its credit administration, its risk-rating criteria, or any other aspect of its credit risk management. Examiners should ensure that the review covers all the criteria used for assessing and rating the quality of credit risk management as outlined
in the risk matrix. The review may be accomplished by reviewing credit files, approval documents, and loan committee minutes. Documentation of the review of credit files may normally be limited to summary comments detailing the loan classification and the facts supporting it.

7. Assess the bank’s compliance with prudential requirements. Findings should be communicated to the examiner reviewing Management.

8. If the bank’s activities, risk profile, or risk controls have changed significantly, or if review of the above information raises substantive issues, the examiner should expand the scope to include additional objectives or procedures, as appropriate. If this review does not result in any significant changes or issues, conclude the asset quality and credit risk review.

2.2. Standard assessment

Examiners should select the appropriate objectives and procedures necessary to assess the bank’s condition and risks.

Objective 1

Determine the quantity of credit risk inherent in the loan portfolio.

Procedures

In addition to procedures 1, 2, 3, 4 and 5 in the minimum scope assessment section, perform the following additional procedures:

1. Review prudential reports and other regulatory information and correspondence provided by the bank to assess the size, composition and trends in the loan portfolio and any off-balance sheet exposures. Consider:

   a. Current and planned loan growth in relation to the bank’s capital and risk limits;
   b. Areas of high growth;
   c. Internal portfolio management reports (loan policy exceptions, concentrations of credit, etc.);
   d. Unfounded and/or un-drawn loan commitments and other off-balance sheet items; and,
   e. Any other information related to the risk characteristics of the loan portfolio such as economic indicators, industry trends, and new products planned or already initiated.
2. Use the bank’s reports to select an appropriate sample of loans from the various sectors of the bank’s loan portfolio (commercial, retail, etc.). Consult with the EIC when selecting the sample. Consider:

   a. Large loans that is 10% or more of Tier I capital;
   b. Significant credit concentrations by industry, regions, etc.;
   c. New loans in new loans products and/or portfolios experiencing rapid growth;
   d. Insider loans and loans to affiliates;
   e. Loans previously identified as having structural weaknesses, loans that are exceptions to lending policies, risk selection, and underwriting standards;
   f. Loans or lending concentrations to businesses or industries exhibiting signs of weakness or higher risk;
   g. Off-balance sheet commitments;
   h. Representative sample of standard or “pass” rated loans using accepted statistical sampling techniques.

Credit risk typically poses the largest single risk to earnings and capital with loans forming the largest portion of total assets. The loan portfolio therefore forms a significant percentage of assets to be reviewed.

The size and composition of the loan sample should be commensurate with the quality of credit risk, the adequacy of risk management, the bank’s condition, and the objectives of the asset quality and credit risk review. The size of the sample for moderate to high level of risk must include an acceptable sample pursuant to the risk level.

The types of loans in the sample are as important as how much of the portfolio is reviewed. The sample should be skewed toward the predominant risks in the portfolio. The higher the risk posed to the bank, the more comprehensive the coverage and testing.

In a stable, well-managed institution exhibiting few signs of change, examiners should sample a smaller number of new and pass-rated credits for the purpose of determining the continued adequacy of loan quality and credit risk management.

If the number of exceptions to sound underwriting practices or risk selection practices is significant, or if the bank’s risk identification or credit administration is suspect or deficient, the examiner should expand the sample to determine the cause, seriousness, and effect of the problems on credit quality. Additional samples may also be required, for example, when there has been significant growth, the loan or product mix changes, credit or economic conditions deteriorate, strategic direction or key personnel change, or loan portfolio management is suspect or deficient. The additional sample should target lending areas that prompted the expanded loan coverage.
3. Analyze credits and discuss on them sufficiently with lending personnel to determine a rating and classification for each loan reviewed.
4. Document and support the reasons for each loan classification.
5. Maintain a list of loans identified as having structural weaknesses.
6. Maintain a list of loans with insufficient information on credit or collateral.
   Consider:
   a. Patterns or root causes of exceptions; and,
   b. Relation of exceptions to credit processes.
7. For retail loans, perform a portfolio analysis. Consider:
   a. Size of the portfolio and rate of growth;
   b. Changes in products, marketing channels, underwriting standards, operations, and technology;
   c. Level and trends in delinquencies and losses;
   d. Levels and trends in restructuring and renewals.
8. Based on the results of the portfolio analysis of retail loans, select a statistical sample of loans to determine the bank’s underwriting and account management practices.
9. Determine the credit risk inherent in the loan portfolio as a whole, considering the risk rating profile, underwriting and risk selection practices, concentrations, loan policy exceptions, credit and collateral exceptions, pricing, collateral coverage, adequacy of analysis and credit administration practices, economic indicators, and quantity of loans subject to classification.

Objective 2

Determine the quantity of credit risk associated with assets other than loans.

Procedures

1. As appropriate, obtain and review a list of the following items:
   a. Placements with other banks;
   b. Inter-bank loan receivables;
   c. Commercial bills;
   d. Sundry debtors;
   e. Security investments;
   f. Other asset accounts with material balances.
2. Obtain a list of classified investments and other appropriate findings regarding the quality and composition of investments from the examiner evaluating the investment portfolio.

3. In discussion with bank management and based on the review of assets listed above, determine if any items should be classified or charged off.

Objective 3

Determine the adequacy of the allowance for loan and lease Losses (ALLL).

Procedures

1. Evaluate the method used to determine the ALLL balance. Consider:
   a. The reasonableness of management’s process;
   b. The quality and adequacy of the supporting documentation;
   c. Findings from the asset quality and credit risk review.

2. Determine if the ALLL methodology is flawed, and if so, consult with the EIC to independently determine the adequacy of the ALLL balance. If the ALLL is deemed inadequate:
   a. Calculate the necessary provision to restore the ALLL to an adequate level;
   b. Direct bank management to make any necessary adjustments to the bank’s books of accounts and regulatory reports;
   c. As appropriate, share these findings with other examiners.

Objective 4

Determine the quality of credit risk management systems.

Procedures

1. Determine whether the number and nature of credit, collateral, and policy exceptions, risk rating changes, and/or other loan review findings raise concerns about the quality of the credit administration function.

2. Determine whether the number, experience and compensation of loan management and supporting personnel are adequate to effectively manage the level of credit risk inherent in the loan portfolio.

3. Assess the timeliness, completeness, accuracy, and relevance of MIS for credit risk. Consider the sources of reports, controls over the preparation of reports, and whether the reports’ accuracy is independently validated. Risk management
reports should cover major sources of credit risk identified in objectives above. This review should be coordinated with the examiners responsible for all areas of the examination, including internal control, to avoid duplication of effort. Findings should be communicated to the examiner reviewing operational risk.

4. Using the findings from the previous objectives, consult with the EIC and other appropriate examiners to make preliminary judgments on the adequacy of portfolio risk management systems. Consider whether:

   1. The BOD and Management recognize and understand existing and emerging risks;
   2. The BOD establishes, communicates, and controls risk limits;
   3. Management measures risk in an accurate and timely manner; Management accurately and appropriately monitors established risk levels.

5. Assess the bank’s system of internal control over the credit function. Examiners should take into consideration the relevant controls listed in objective 5 of the “Audit and Internal Control” section of the standard assessment. Examiners should also take into consideration other controls pertinent to the credit function.

**Objective 5**

Assess the bank’s compliance with prudential requirements. Findings should be communicated to the examiner reviewing Management.
Objective 6

Recommend corrective action.

Procedures

Prior to performing the procedures below, determine whether to expand the procedures. Consider whether there is a need for expanded procedures for the areas of concerns. Expanded procedures are available in this Examination Manual. The extent to which examiners will expand procedures will be decided on a case-by-case basis. If expanded procedures are not required, proceed as follows:

1. Discuss the preliminary conclusions with the EIC, addressing:
   
   a. The quantity of credit risk;
   b. The quality of credit risk management;
   c. The net risk and direction of credit risk. As appropriate, update the Risk Matrix;
   d. The Asset quality rating;
   e. Directives and/or recommendations, if any.

2. Provide and discuss with management a list of credit and collateral exceptions, policy exceptions, loans with structural weaknesses, and classified assets, including any differences between the bank’s internal loan classification and the examiners’ classification.

3. In consultation with the EIC and other examiners, identify and communicate to other examiners, as appropriate, any conclusions and findings from the asset quality and credit risk review that are relevant to other areas being reviewed.

4. Use the results of the foregoing procedures and any other applicable examination findings to compose comments on asset quality and credit risk management for the ROE.
C. LIQUIDITY RISK EXAMINATION

1. Description

1.1. Reach a final, overall conclusion for liquidity based on the quantity, level, and direction of risks based on the following:

   a. Liquidity rating (1, 2, 3, 4, or 5);
   b. Liquidity risk rating (Low, Moderate, or High);
   c. Direction of liquidity risk (Decreasing, Stable or Increasing).

1.2. Complete this section’s objectives to assign the liquidity component and liquidity risk ratings, respectively. In assigning the ratings, examiners should consult with the EIC and other appropriate examiners. When assigning the liquidity component and liquidity risk ratings, examiners should take into consideration rating factors outlined in the CAMELS Rating Guidelines.

2. Assessment procedures

2.1. Minimum scope assessment

Objective

Determine the quantity of liquidity risk, the quality of liquidity risk management, and the liquidity component rating.

Procedures

1. At the beginning of the examination, hold discussions with management covering actual or planned:

   a. Changes in liquidity risk management;
   b. Changes in liquidity planning or funding sources and needs;
   c. Changes in investment strategy;
   d. Changes in the liquidity policy or contingency funding plan.

2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any issues that require follow-up in this area.

3. Obtain liquidity-related information from the examiner assigned to review BOD meeting minutes, and minutes of the BOD committee responsible for overseeing liquidity risk, and follow-up, as appropriate, on issues requiring attention.
4. Discuss with the examiner responsible for completing the “Audit and Internal Control” section of the standard assessment, and follow-up on any significant liquidity audit findings.

5. Obtain and review the following information and documents, as appropriate:
   a. The bank’s liquidity reports including the most recent Maturity Gap Report;
   b. Asset and Liability Committee (ALCO) minutes and reports since the last on-site examination.

6. Assess the bank’s compliance with prudential requirements. Findings should be communicated to the examiner reviewing Management.

7. Determine whether there have been any significant changes in the bank’s activities, risk profile, or risk controls after consultation with examiners reviewing other areas. If not, conclude the liquidity risk review by assigning an appropriate rating.

8. If significant changes in the bank’s activities, risk profile or risk controls have taken place, expand the scope of review to include additional objectives or procedures outlined under standard assessments.

2.2. Standard assessment

Objective 1

Determine the adequacy of liquidity and the quantity of liquidity risk.

Procedures

In addition to procedures 1, 2, 3, 4 and 5 outlined under the minimum scope assessment, perform the following additional procedures:

1. Obtain and review the following items:
   a. Most recent liquidity reports;
   b. Contingency funding plan;
   c. Findings from off-site monitoring reports;
   d. List of investments;
   e. Any other information or reports management used (ALCO reports, minutes and packages, etc.).
2. Discuss current investment, liquidity, and funds management strategies with appropriate management.

3. Identify volume and trends in funding by reviewing:
   a. Sources of funding, e.g. retail vs. wholesale;
   b. Projected funding needs vs. available sources;
   c. Wholesale funding that may be credit sensitive;
   d. Funding concentrations;
   e. Use and reliance on liabilities with short-term maturities;
   f. Asset growth projections;
   g. Liquid assets levels and trends;
   h. Off-balance-sheet commitments;
   i. Proportion of long term assets financed by short term liabilities.

4. Evaluate the adequacy of sources of funds to meet anticipated or potential needs. Consider:
   a. Money market assets relative to short-term liquidity needs;
   b. Other currently available asset liquidity relative to overall liquidity needs e.g. free (unencumbered) securities;
   c. Other potential sources of asset liquidity (cash flow from loans, investments, and off-balance-sheet contracts, etc.);
   d. Estimated capacity to borrow from inter-bank market;
   e. The bank’s capacity to increase deposits through pricing and direct-marketing campaigns to meet medium- and long-term liquidity needs;
   f. The bank’s capacity to borrow under the CBK collateralized program or other similar collateralized borrowing facilities;
   g. The capacity to issue longer-term liabilities and capital instruments to meet medium- and long-term funding liquidity needs. Options may include:
      - Deposit mobilization;
      - Subordinated debts;
      - Stocks/shares.

5. Evaluate the quality of the investment portfolio as a potential source of liquidity. Consider the following:
   a. Percentage and quality of investment portfolio that is un-pledged;
   b. Level and impact of portfolio depreciation;
   c. Maturity distribution of the investment portfolio;
   d. Distribution of securities designated held-to-maturity and available-for-sale;
   e. Trends in monthly cash flow from the investment portfolio;
   f. Potential impact of embedded options on the cash flow patterns.
6. If the bank relies significantly on wholesale/corporate funding, review factors that influence wholesale/corporate funds' providers. Consider the following:

   a. Current asset quality and potential for deterioration;
   b. Earnings performance and expectations;
   c. Changes in senior bank management;
   d. Negative media attention;
   e. Legal restrictions.

7. If the bank relies significantly on wholesale/corporate funding, discuss wholesale funding with management to determine:

   a. How wholesale funding fits into the overall asset/liability strategy;
   b. What types of mismatches exist;
   c. Whether the wholesale funding strategy is meeting profit expectations.

8. Considering the foregoing and other relevant risk assessment factors, consult with the EIC and other appropriate examiners to determine the quantity of liquidity risk.

**Objective 2**

Determine the quality of liquidity risk management.

**Procedures**

In addition to procedures 1, 2, 3, 4 and 5 already performed under objective 1, perform the following additional procedures:

1. Determine whether the BOD has clearly articulated policies and guidelines outlining lines of authority/responsibility for the management of liquidity and the BOD’s tolerance for liquidity risk. Consider whether:

   a. There is a measurement system that captures and quantifies liquidity risk;
   b. Limits/guidelines are defined and communicated to management and other relevant staff;
   c. Limits/guidelines are reasonable;
   d. Planning, budgeting, and new product areas consider liquidity in their decisions.

2. Determine whether management has planned for adequate sources of liquidity to meet current and potential funding needs.
3. Review the contingency funding plan and determine whether it adequately details management responsibilities, quantifies potential funding needs/sources under multiple scenarios, and prioritizes management action to respond to funding needs. Ensure that the plan is appropriate given the complexity of the bank’s circumstances.

4. Determine whether strategies used to achieve the desired mix and maturities of assets and liabilities are adequate. Consider:

   a. Discussing with management the bank’s liquidity risk strategies;
   b. Competitive pressures in the bank’s market, considering all funding sources (e.g. branch network, wholesale funding, etc.);
   c. Maturity matching;
   d. Asset purchases or sales or borrowings and subordinated debts;
   e. Pricing of loans and deposits; and,
   f. Existence of off-balance-sheet items, such as credit lines, derivative contracts, and other commitments.

5. Assess the timeliness, completeness, accuracy, and relevance of MIS for liquidity. Consider the sources of reports, controls over the preparation of reports, and whether the reports’ accuracy is independently validated. This review should be coordinated with the examiners responsible for all areas of the examination to avoid duplication of effort. Findings should be communicated to the examiner reviewing operational risk. Consider whether MIS monitors:

   a. Compliance with risk limits;
   b. Sources and uses of funds;
   c. Funding concentrations;
   d. Funding costs;
   e. Availability under wholesale funding lines; and,
   f. Projected funding needs.

6. Assess the system of internal control over liquidity. Examiners should also take into consideration other controls pertinent to liquidity.

7. Using the findings from the foregoing, consult with the EIC and other appropriate examiners to determine the quality of liquidity risk management.

**Objective 4**

Determine the composition and quality of the investment portfolio

**Procedures**

1. Review the bank’s MIS reports to evaluate:
Objective 5

Assess the bank’s compliance with prudential requirements on liquidity.

Procedures

1. Assess the bank’s compliance with the law regarding liquid assets and prudential liquidity ratios. Findings should be communicated to the examiner reviewing Management.

Objective 6

Communicate examination findings and recommend and initiate appropriate corrective action.

Procedures

1. Provide the examiner evaluating credit risk with a list of classified investments, and communicate findings to other examiners, as appropriate.
2. In consultation with the EIC and other examiners, identify and communicate to other examiners, as appropriate, any conclusions and findings from the liquidity review that are relevant to other areas being reviewed.

3. In discussion with the EIC, provide preliminary conclusions about:
   a. The quantity of liquidity risk;
   b. The quality of liquidity risk management;
   c. The net risk and direction;
   d. The liquidity rating;
   e. Potential or actual impact of liquidity risk on earnings and capital;
   f. Directives and/or recommendations, if any.

4. Discuss findings and conclusions with management regarding the quantity and quality of the liquidity risk and the liquidity risk management. Considerations for discussions may include:
   a. Overall conclusions;
   b. Recommendations;
   c. Deficiencies;
   d. If applicable, commitment from management to correct violations of laws and/or matters requiring BOD’s attention.

5. As appropriate, prepare comments for inclusion in the ROE. Considerations for comments may include:
   a. The quantity of liquidity risk;
   b. The quality of liquidity risk management;
   c. The net risk and direction;
   d. The liquidity rating;
   e. Potential or actual impact of liquidity risk on earnings and capital;
      and,
   f. Directives and/or recommendations, if any.
D. INTEREST RATE RISK EXAMINATION

1. Description

1.1. Conclusion: Reach a final overall conclusion for interest rate risk (IRR) based on:

- An assessment of IRR (Low, Moderate, or High);
- Direction of IRR (Decreasing, Stable or Increasing).

1.2. Complete this section’s objectives to assign the IRR rating. In assigning the rating, the examiner should consult with the EIC and other appropriate examiners.

2. Assessment procedures

2.1. Minimum scope assessment

Objective

Determine the quantity of risk and the quality of risk management for IRR.

Procedures

1. At the beginning of the examination, hold discussions with management covering actual or planned:

   a. Changes to the IRR policy (i.e., limit structures, risk measurement, etc.);
   b. Changes in the IRR management process;
   c. Material changes in the bank’s asset and liability structure;
   d. Changes in the investment portfolio and its impact on IRR.

2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any issues in this area that require follow-up.

3. Obtain IRR related information from the examiner assigned to review BOD minutes. In addition, review the ALCO minutes to understand the bank’s IRR management practices.

4. Discuss with the examiner responsible for completing the “Audit and Internal Control” section of the standard assessment whether there are any significant IRR
audit findings that require follow-up, or whether a review of audit work papers is required.

5. Obtain and review the bank’s most recent IRR reports, including ALCO reports.

6. Assess the bank’s compliance with prudential requirements. Findings should be communicated to the examiner reviewing Management.

7. If the bank’s activities, risk profile, or risk controls have changed significantly, or if review of the above information raises substantive issues, the examiner should expand the activity’s scope to include additional objectives or procedures, as appropriate. If this review does not result in any significant changes or issues, conclude the IRR review.

2.2. Standard assessment

**Objective 1**

Determine the quantity of IRR.

**Procedures**

In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:

1. At the beginning of the examination, hold discussions with management covering actual or planned:

   a. Changes to the IRR policy (i.e., limit structures, risk measurement, etc.);

   b. Changes in the IRR management process;

   c. Material changes in the bank’s asset and liability structure;

2. Review exposure to on- and off-balance-sheet positions. Consider:

   a. The composition and maturities of assets and liabilities (Gap Analysis);

   b. The volatility of the net interest margin over time;

   c. The level and impact of basis risk, yield curve risk, options risk, and re-pricing risk; The support provided by low-cost, stable non-maturity deposits (i.e., demand deposits, savings).

3. Review the level and trend of earnings-at-risk, if any, as indicated by the bank’s risk measurement system.
4. Review the exposure to the bank’s capital. If the bank has a significant volume of medium-term to longer term re-pricing risk and/or options-related positions, review the level and trend of exposure to the capital.

5. Review the use and determine the bank’s exposure to derivative products, if applicable.

6. Using the findings from performing the above procedures and considering the relevant factors, consult with the EIC and other appropriate examiners to determine the quantity of IRR.

**Objective 2**

Determine the appropriateness and effectiveness of the risk management practices over the investment portfolio.

**Procedures**

In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:

1. Determine whether the BOD has approved policies establishing responsibility for the management of IRR, communicating risk tolerance, and providing sound guidelines for the management of IRR.

2. Assess the effectiveness of management and the BOD in overseeing IRR. Consider:
   a. The existence and reasonableness of BOD-approved limits for exposure to IRR;
   b. Compliance with established risk limits.

3. Determine whether the risk management system used to measure the effect of interest rate changes to earnings is appropriate for the level and complexity of the bank’s exposure and whether the major assumptions used by the bank are reasonable.

4. Determine whether the risk management system used to measure the effect of interest rate changes to economic value is appropriate for the level and complexity of the bank’s exposure and whether the major assumptions used by the bank are reasonable.
5. Determine whether assumptions used in the risk measurement system are documented with sufficient detail so as to allow verification of their reasonableness and accuracy.

6. Evaluate management’s ability and effectiveness in managing IRR. Consider:
   
   a. The level of understanding of the dynamics of IRR;
   b. The ability to respond to competitive pressures in financial and local markets;
   c. Whether a balanced presentation of risk and return are appropriately considered in asset/liability strategies;
   d. The ability to anticipate and respond to adverse or changing economic conditions and interest rates;
   e. Whether staff skills are appropriate for the level of complexity and risk.

7. Assess the timeliness, completeness, accuracy, and relevance of MIS. Consider the sources of reports, controls over report preparation, and whether reports’ accuracy is independently validated. Findings should be communicated to the examiner reviewing operational risk.

8. Determine whether a competent, independent review process periodically evaluates the effectiveness of the IRR management system. In reviewing measurement tools, examiners should determine whether the assumptions used are reasonable and whether the range of interest rate scenarios considered are appropriate.

9. Assess the adequacy of the system of internal control over IRR. Examiners should also take into consideration other controls pertinent to IRR.

10. Using the findings from the above procedures, determine whether the risk management system to identify, measure, monitor, and control or mitigate IRR is effective.

**Objective 3**

Assess the bank’s compliance with prudential requirements on IRR.

**Objective 4:**

Determine whether to expand the procedures.

Consider whether there is a need for expanded procedures for the areas of concerns. Expanded procedures are available in this Examination Manual. The extent to which examiners will expand procedures will be decided on a case-by-case basis.
Objective 5:

Recommend corrective action.

1. In consultation with the EIC and other examiners, identify and communicate to other examiners, as appropriate, any conclusions and findings from the IRR review that are relevant to other areas being reviewed.

2. In discussion with the EIC, provide preliminary conclusions about:
   a. The quantity of IRR;
   b. The quality of IRR management;
   c. The net risk and direction of IRR;
   d. Potential or actual impact of IRR on earnings and capital.

E. OPERATIONAL RISK EXAMINATION

1. Description

1.1. Reach a final overall conclusion for operational risk based on:
   - Operational risk assessment (Low, Moderate or High)
   - Direction of Operational risk (Decreasing, Stable or Increasing).

1.2. Complete this section’s objectives to assess operational risk. The examiner should consult with the EIC and other appropriate examiners.

2. Assessment procedures

2.1. Minimum scope assessment

Objective 1

Determine the quantity of risk and quality of operational risk management.

Procedures

1. At the beginning of the examination, hold discussions with management covering:
a. Actual system failures, service interruptions and frauds since previous examination;
b. Actual or planned changes to the current or new business initiatives;
c. Changes to the policies and procedures to accommodate new activities or products;
d. How management monitors the quality and reliability of outsourced services and support functions;
e. Changes in the financial condition of, or quality of service provided by IT vendors and/or other service providers;
f. Actual or planned changes in vendors, systems, applications, distribution channels, or personnel;
g. Changes in the information security or contingency planning processes;
h. Changes in the processes or reports management use to monitor operational risk;
i. Impact of models not performing as intended on earnings, risk management, and ALLL adequacy; and,
j. Impact of the changes noted above on the institution’s operational risk.

2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any issues that require follow-up in this area.

3. Obtain operational risk related information from the examiner assigned to review BOD minutes.

4. Discuss with the examiner responsible for completing the “Audit and Internal Control” section of the standard assessment, any significant operational risk audit findings that require follow-up.

5. Review information and reports on:
   a. Compliance with internal policies and procedures, legal and regulatory requirements;
   b. External market information about events and conditions that may have an impact on the institution’s operations;
   c. Results of tests of the institution’s IT security and management’s response;
   d. Results of tests of the institution’s contingency plan and management’s response;
   e. Operational risk profile of the institution submitted to the BOD;
   f. Recent MIS reports on frauds, business disruption, system failures, and processing losses;
   g. Major IT initiatives and developments;
   h. Business continuity plans and backup site availability.

6. Assess the bank’s compliance with laws and other prudential requirements which include:
   a. Laws in force;
   b. Regulations in force;
   c. Other various CBK issuances.
Objective 2

Communicate examination findings and initiate appropriate corrective action

Procedures

1. In consultation with the EIC, provide conclusion of findings. Consider:
   a. Findings from all other areas under examination;
   b. Overall conclusion;
   c. Any recommendations to management.

2. Expand the activity’s scope to include additional objectives or procedures, as appropriate, if the institution’s activities, risk profile, or risk controls have changed significantly, or if review of the above information raises substantive issues.

3. If this review does not result in any significant changes or issues, conclude the operational risk management review by preparing, as appropriate, comments for inclusion in the ROE.

2.2 Standard assessment

Objective 1

Determine the quantity of risk and quality of operational risk management.

Procedures

In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:

Objective 2

Assess the quality of operational risk management.

Procedures

In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:
1. Review organizational chart, job descriptions, compensation, staff turnover, and training programs to ensure that the bank has a sufficient number of personnel with the expertise the bank requires.

Liaise with examiners assessing management and the Audit function and Internal Controls to avoid duplication of effort.

2. Review the effectiveness of the bank’s management and monitoring of vendor and other service providers by evaluating the following:
   a. Vendor/service provider selection process;
   b. Contract guidelines, including customer privacy protections;
   c. Monitoring of vendor or service provider performance under the contract, including availability of financial information and access to operations and security audits of the service provider;
   d. As applicable, availability of, or access to, application source code and documentation for programs not developed or maintained by the bank.

3. Review insurance policies to determine whether they are current and provide adequate coverage.

4. Determine whether there is separation of duties and responsibilities in the operation and data processing areas. Consider:
   a. Input preparation;
   b. Data entry;
   c. Operation of the computer system;
   d. Processing of rejects (unacceptable information) and un-posted transactions;
   e. Verification of transactions;
   f. Exceptions reports;
   g. Statement and report preparation and distribution.

5. Determine the adequacy of the written business resumption contingency plan. Consider whether:
   a. The plan gives alternative mechanisms for resuming service in the event of an outage;
   b. The plan adequately addresses all mission-critical activities or services;
   c. The BOD of directors or a BOD committee annually reviews the plan.

6. Determine whether annual validation of the contingency plan, including backup/alternate site testing is conducted, and whether the BOD and senior management are apprised of the scope and results of the backup test.
7. Determine the adequacy of, and compliance with, the IT security policy. Consider whether the policy:

   a. has been approved and is periodically reviewed by the BOD;
   b. is adjusted, as appropriate, for changes in the bank’s (or Vendor’s) processing environment or systems;
   c. prescribes reports to the BOD (or BOD committee) on the overall status of the IT security and the bank’s compliance with the policy.

8. Review MIS reports for significant IT systems and activities to ensure that risk identification, measurement, monitoring and control/mitigation are commensurate with the complexity of the bank’s technology and operating environment. MIS should be timely, accurate, complete, and relevant. Consider:

   a. Systems capacity, including peak processing volumes;
   b. Up-time performance (within time) and processing interruptions;
   c. Network monitoring including penetration attempts and intruder detection;
   d. Activity logs and security reports for operations, program and parameter changes, terminals use, etc.:
   e. Volume and trends of losses from errors, fraud, and un-reconciled items.

**Objective 3**

Note: The review should be coordinated with the examiners responsible for the review of other risks and the internal control portion of the examination to avoid duplication of effort.

**Procedures**

1. Determine whether there are adequate controls and audit trails over master file change requests such as address changes, due dates, loan payment extensions or renewals, loan or deposit interest rates, and the service charge indicator. Consider:

   a. Individuals authorized to make changes and potential conflicting job responsibilities;
   b. Documentation/audit trail of authorized changes;
   c. Procedures used to verify the accuracy of master file changes.

2. Assess adequacy of controls over changes to systems, programs, data files, and personal-computer-based applications. Consider:

   a. Procedures for implementing program updates, releases, and changes;
   b. Controls to restrict and monitor use of data-altering utilities;
c. Process management uses to select system and program security settings (i.e., whether the settings were made based on sound technical advice or were simply default settings);
d. Controls to prevent unauthorized changes to system and programs security settings;
e. Process and authorizations to change application parameters.

3. Determine whether employees’ levels of online access (blocked, read-only, update, override, etc.) match current job responsibilities.

4. Evaluate the effectiveness of password administration for employee and customer passwords considering the complexity of the processing environment and type of information accessed. Consider:

   a. Whether passwords are confidential (known only to the employee/customer);
   b. Whether the procedures to reset passwords ensure that confidentiality is maintained;
   c. Frequency of required changes in passwords;
   d. Password design (number and type of characters);
   e. Security of passwords while stored in computer files, during transmission, and on printed activity logs and reports.

5. Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.

**Objective 4**

Evaluate the effectiveness of controls to protect data confidentiality, i.e., to prevent the inadvertent disclosure of confidential information.

**Procedures:**

1. Evaluate systems used to monitor access and detect unauthorized internal or external attempts to access the bank’s systems (i.e., intruder detection).

2. Evaluate control and security for data transmitted to or from remote locations. Consider:

   a. Type of data transmitted;
   b. Use of encryption or other security techniques (e.g., firewalls);
   c. Access to network components (servers, routers, phone lines, etc.) that support data transmission.
3. Evaluate controls over remote access (by modem or Internet link) to ensure use/access by authorized users only.

**Objective 5**

Assess the adequacy of the bank’s policies and procedures to ensure the availability of automated information and ongoing support for IT-based products and services.

**Procedures**

1. Evaluate planning for event management activities. Consider:
   
   a. Emergency procedures and evacuation plans;
   b. Response to network attack or penetration;
   c. Reporting to appropriate regulatory or law enforcement agencies.

2. Assess processes and procedures to prevent destruction of electronic files and other storage media. Consider:
   
   a. Frequency of file backup;
   b. Access to backup files and storage media (disks, tapes, etc.);
   c. Location of off-site file storage;
   d. Virus protection for networks and personal computers.

3. Determine whether only authorized personnel have access to the computer area, electronic media, supplies of negotiable items, and whether equipment and networks supporting mission-critical services are appropriately secured. Consider physical security as well as environmental controls.

**Objective 6**

Assess the bank’s processes for managing operational risk

**Procedures**

1. Analyze applicable internal and external audit reports as they relate to operational risks.

2. Determine whether the volume and nature of fraud and processing losses, network and processing interruptions, customer-reported processing errors, or audit criticisms lower the quality of automated activities and services.
3. Determine whether the bank’s risk assessment process for customer information and its test of key controls, systems, and procedures in the bank’s system security are commensurate with the sensitivity of the information and the complexity and scope of the bank’s activities.

4. Assess the timeliness, completeness, accuracy, and relevance of MIS for operational risk. Consider the source of reports, controls over report preparation, and independent validation of report accuracy. Risk management reports should cover major sources of operational risk identified above.

5. Using the findings from the above procedures, combined with the information from the EIC and other appropriate examiners, make preliminary judgments on the quality of operational risk management systems. Consider whether:
   a. The BOD and management recognize and understand existing and emerging risks;
   b. The BOD establishes and communicates policies for operational risk management;
   c. Management measures risk in an accurate and timely manner;
   d. Management accurately and appropriately monitors established risk limits.

**Objective 7**

Assess the bank’s compliance with laws and other prudential requirements.

**Procedures:**

1. Assessment on compliance with laws and other prudential requirements should include the following:
   a. Laws and regulations;
   b. CBK Regulations;
   c. Other CBK issuances.

   Findings should be communicated to the examiner reviewing Management.

**Objective 8**

Communicate examination findings and initiate appropriate corrective action.

**Procedures:**

1. In consultation with the EIC, provide conclusion of findings and arrive at a rating of operational risk. Consider:
   a. Findings from all other areas under examinations;
   b. Overall conclusion;
c. Any recommendations to management.

2. Determine the impact on the aggregate risk and direction of risk assessments for any applicable risks identified by performing the above procedures.

3. Determine in consultation with the EIC, if the risks identified are significant enough to merit bringing them to the BOD’s attention in the ROE.

4. Discuss findings and conclusions with management regarding operational risk. Considerations for discussion may include:
   a. Overall conclusions;
   b. Recommendations;
   c. Violations of laws and regulations;
   d. Deficiencies; and,
   e. If applicable, commitment from management to correct the deficiencies noted and/or matters requiring BOD Attention.

5. As appropriate, prepare comments for inclusion in the report of examination. Considerations for comments may include:
   a. Amount of operational risk;
   b. The quality of risk management;
   c. The net risk and direction of operational risk;
   d. Impact of the actual or potential exposure to operational risk on earnings and capital;
   e. Directives/recommendations, if any.

**F. CAPITAL ADEQUACY EXAMINATION**

1. Description

1.1. Conclusion:
   
   - Capital is rated as 1, 2, 3, 4, or 5.

1.2. Complete this section’s objectives to assign the capital adequacy rating. In assigning the rating, the examiner should consult with the EIC and other appropriate examiners. When assigning the capital adequacy rating, examiners should take into consideration rating factors outlined in the CAMELS Rating Guidelines.
2.2. Assessment procedures

2.1. Minimum scope assessment

Objective 1

Determine the capital rating and any potential impact on the bank’s risk assessment.

Procedures

1. At the beginning of the examination, hold discussions with management covering:
   a. The bank’s present financial condition and its future plans regarding dividends policy, capital growth and deployment, new products, and other strategic initiatives likely to have a significant impact on capital;
   b. Current shareholding structure of the bank and actual or planned changes in controlling ownership, if any.

2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any problems in this area that require follow-up.

3. Obtain capital adequacy related information from the examiner assigned to review BOD minutes.

4. Discuss with the examiner responsible for completing the “Audit and Internal Control” section of the standard scope assessment and obtain any significant capital adequacy audit findings that require follow-up.

5. Obtain and review the following information and documents, as appropriate:
   a. The bank’s current risk-based capital computation (regulatory capital);
   b. Results from other areas of examination that may affect capital adequacy (e.g. earnings, asset quality, etc.).

6. Review the following information to identify trends in the bank’s capital adequacy:
   a. Reports from offsite financial analysis monitoring activities by CBK;
   b. Reports used by bank management to monitor and project capital requirements;
   c. The bank’s ratios in comparison to those of its peers.
7. Assess the bank’s compliance with prudential requirements. Findings should be communicated to the examiner reviewing Management.

8. After consultation with examiners reviewing other areas, the examiner should consider if the bank’s activities, risk profile, or risk controls have changed significantly. If review of the above information raises substantive issues, the examiner should expand the activity’s scope to include additional objectives or procedures, as appropriate. If this review does not result in any significant changes or issues, conclude the capital review.

2.2. Standard assessment

**Objective 1**

Determine the adequacy and quality of capital.

**Procedures**

In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:

1. Assess the likely impact of the following on current or future capital adequacy of the bank:
   
   a. Dividends and dividends policy;
   b. Earnings;
   c. Asset quality and adequacy of allowance for loan and lease losses;
   d. Historical and planned growth;
   e. On- and off-balance-sheet activities;
   f. Strategic initiatives including any plans to raise and deploy significant new injections of capital;
   g. Financial plans and budgets, including replacement costs for fixed assets and technology;
   h. New products, services, or distribution channels;
   i. Related organizations (parent, subsidiary, associate, etc.).

2. Evaluate other sources of capital. Consider:

   a. The financial condition of principal shareholders, parent, or subsidiaries;
   b. The potential for public or private offerings.
3. Evaluate in consultation with the EIC and other examiners, information about the net risks or direction of any risks that may have an adverse impact on current or future capital adequacy.

**Objective 2**

Determine the quality of risk management systems through discussions with management and analysis of applicable information.

**Procedures**

In addition to procedure 7 under minimum scope core assessment, perform the following additional procedures:

1. Assess the bank’s system of internal controls over the capital accounts. Also take into consideration other controls pertinent to capital.
2. Assess the timeliness, completeness, accuracy, and relevance of MIS for capital. Consider the sources of reports, controls over the preparation of reports, and whether the reports’ accuracy is independently validated. This review should be coordinated with the examiners responsible for all functional areas of the examination, including internal controls, to avoid duplication of effort; findings should be communicated to the examiner reviewing operational risk.

**Objective 3**

Recommend corrective action, if any.

**Procedures**

1. Adjust the bank’s reported capital computation to reflect the results of the examination by taking into account:
   
   a. Recommended additions to the ALLL;
   
   b. Errors, if any, in financial reporting;
   
   c. Recommended direct asset charge-offs, if any.

2. In consultation with the EIC and other examiners, identify and communicate to other examiners as appropriate any conclusions and findings from the capital review that are relevant to other areas being reviewed.

3. In discussion with the EIC, provide preliminary conclusions about:
   
   a. The Capital rating;
b. Directives and/or recommendations, if any.

4. Discuss and agree with the bank’s management your preliminary rating and recommendations as concluded in procedure 3 above.

5. Use the results of the foregoing procedures and any other applicable examination findings to compose appropriate comments for the ROE.

G. EARNINGS EXAMINATION

1. Description

1.1. Conclusion:

- Earnings are rated as 1, 2, 3, 4, and 5.

1.2. Complete this section’s objectives to assign the earnings rating. In assigning the ratings, examiner should consult with the EIC and other appropriate examiners. When assigning the earnings rating, examiners should take into consideration rating factors outlined in the CAMELS Rating Guidelines.

2. Assessment procedures

2.1. Minimum scope assessment

Objective 1

Determine the earnings component rating and any potential impact on the bank’s risk assessment.

Procedures

1. At the beginning of the examination, discuss with the bank’s management the following:

   a. Budget or budgeting process, and planned changes, if any;
   b. Present financial condition and management’s future expectations; and,
   c. Earnings trends and management’s explanation for the variances.
2. Review the previous ROE, prudential reports and other regulatory information and correspondence to identify any issues in earnings that require follow-up.

3. Obtain earnings related information from the examiner assigned to review BOD minutes.

4. Discuss with the examiner responsible for completing the Audit and Internal Controls section of the standard scope assessment and obtain any significant audit findings on earnings that require follow-up.

5. Obtain and review the following information and documents, as appropriate:
   a. Business and strategic plan;
   b. Most current balance sheet and income statement;
   c. Budget;
   d. Policies and procedures on suspension of interest on non-performing assets;
   e. Any other reports relating to earnings.

6. Determine whether there have been any significant changes in the bank’s activities, risk profile, or risk controls after consultation with examiners reviewing other areas. If not, conclude the earnings review by assigning an appropriate rating.

7. If significant changes in the bank’s activities, risk profile or risk controls have taken place, expand the scope of review to include additional objectives or procedures outlined under standard scope assessments.

2.2. Standard assessments

Objective 1
Determine the quality and composition of earnings.

Procedures
In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:
1. Identify trends in the bank’s earnings performance and determine whether the bank’s earnings trend is improving, stable or declining by reviewing the following information:
   a. Financial analysis reports compiled from periodic prudential returns;
   b. Bank’s own reports used to monitor and project earnings (e.g. management accounts, variance reports, etc.);
   c. Bank’s current earnings compared with the budget and peer group;
   d. Comparative profitability ratios of the bank’s peer.

2. Discuss with management and obtain explanations on the identified earnings trends and variances.

3. Analyze the bank’s earnings by examining the following:
   a. Composition and major sources of earnings;
   b. Net interest margins;
   c. Non-interest income and expenses;
   d. Loan loss provisions;
   e. Off-balance-sheet items;
   f. Changes in balance sheet composition;
   g. Loan and deposit pricing;
   h. Earnings from affiliates;
   i. Earnings from high-risk lines of business; and,
   j. Bank’s dividend policy.

4. In consultation with the EIC and other examiners, decide whether the level or direction of any risk has an adverse impact on the bank’s current or future earnings.

5. Adjust the bank’s reported earnings to reflect the results of the examination, where necessary, and project the current year’s net income. Distribute adjustments to appropriate examiners.

**Objective 2**

Determine the adequacy of the bank’s budgeting process.

**Procedures:**

1. Review and determine the reasonableness of the following factors in the bank’s budget:
a. Economic, market, and other assumptions;
b. Bank’s business plan and strategies;
c. Variance reports and other supplemental budgeting reports.

**Objective 3**

Determine the quality of risk management systems through discussions with management and analysis of applicable internal and external audit reports, and any other relevant reports.

**Procedures**

1. Assess the bank’s system of internal controls over income and expense accounts. Examiners should also take into consideration other controls pertinent to earnings.

2. Assess the timeliness, completeness and accuracy the financial statements, and other management information reports for earnings. Review:
   a. The source of reports;
   b. The controls over the preparation of reports;
   c. Whether the reports’ accuracy is independently validated.

3. This review should be coordinated with the examiners responsible for all functional areas of the examination, including internal controls, to avoid duplication of effort; findings should be communicated to the examiner reviewing operational risk.

**Objective 4**

Assign rating and recommend corrective action, if any.

**Procedures**

1. In consultation with the EIC and other examiners, identify and communicate to other examiners, as appropriate, any conclusions and findings from the earnings review that are relevant to other areas being reviewed.

2. In consultation with the EIC, arrive at preliminary conclusions on:
   a. The earnings rating; and
   b. Directives and/or recommendations, if any.
3. Discuss and agree with the bank’s management your preliminary rating and recommendations as concluded in procedure 2 above.

4. Using the results of the foregoing procedures and any other applicable examination findings, compose appropriate comments for the ROE.


H. MANAGEMENT EXAMINATION

1. Description

1.1. Conclusion:

- Management is rated as 1, 2, 3, 4, or 5.

1.2. Complete this section’s objectives to assign the management rating. Many of the steps in these examination procedures require gathering information from, or reviewing information with, examiners in other areas. Since other areas may include examination procedures that address management processes, discuss the review with other examiners to reduce burden on the bank and avoid duplication of effort. Share examination data to also have an effective cross check of compliance and help examiners assess the integrity of MIS. When assigning the management rating, examiners should take into consideration rating factors outlined in the CAMELS Rating Guidelines.

2. 2. Assessment procedures

2.1. Minimum scope assessment

Objective 1

Determine the management component rating, and consider the potential impact of these findings on the bank’s risk assessment.

Procedures

1. At the beginning of the examination, discuss with the bank’s management the following:

   a. Any changes or proposed changes to senior management and/or the BOD and its committees;
   b. The bank’s BOD approved strategic plan;
   c. Financial and operational plans, if separate from the strategic plan;
   d. Resources and staffing necessary to accomplish strategic goals;
   e. Any changes in products, services, delivery channels, service providers, etc.;
   f. Management succession plans.
2. Review the following information and documents:
   a. Minutes of the BOD and BOD sub-committees since the last examination;
   b. Minutes of the Management committee since the last examination;
   c. Prior ROE and related management and BOD responses;
   d. Internal/External audit reports; and,
   e. Correspondence between the bank and the CBK.

3. Discuss with the examiner responsible for completing the Audit and Internal Controls section of the minimum scope assessment and obtain any significant findings on both management and Audit and Internal Controls that require follow-up.

4. In consultation with examiners, assess the reviewing other areas, compliance with laws, regulations, and policies relating to bank management. Consider the following:
   a. Possible violations of the laws and regulations;
   b. Whether prior violations of the laws have been appropriately corrected;
   c. Quantity of risk exposure to the bank’s earnings and capital due to non-compliance with laws, regulations, policies, or sound financial practices.

5. Determine whether there have been any significant changes in the bank’s activities, risk profile, or risk controls after consultation with examiners reviewing other areas. If not, conclude the management review by assigning an appropriate rating.

6. If significant changes in the bank’s activities, risk profile or risk controls have taken place, expand the scope of review to include additional objectives or procedures outlined under the standard scope assessment section.

**2.2 Standard assessment**

**Quality of Risk Management**

**Policy**

**Objective 1**

Determine whether the BOD has approved adequate policies for all significant areas of the bank.
In addition to procedures 1, 2, 3, 4, and 5 under minimum scope assessment, perform the following additional procedures:

1. Obtain a listing of all areas of the bank’s operations that are administered under the provisions of objectives and policies as approved by the BOD.

2. Determine whether policies have been implemented. Assess:
   a. Management’s action or inaction to implement appropriate policies and procedures;
   b. Any policies that are not working documents;
   c. The reason why certain policies are not implemented, or if implemented, are not being followed.

3. Determine how the BOD and management ensure that adopted policies are followed and that exceptions are documented.

4. In conjunction with the examiners reviewing each area of the bank, determine if policies are appropriate. (Some testing may be necessary).

Determine the reasonableness of the bank’s vacation policy. Are management and employees required to take two consecutive weeks of vacation, if they are eligible?

Processes

Policy - Making Process

Objective 1

Determine the adequacy of the bank’s operating procedures, programs, and practices.

Procedures:

1. Determine whether the policy-making process takes into account the following:
   a. Regulatory requirements;
   b. Inherent risks;
   c. Strategic, operating, and capital plans;
   d. Bank’s financial condition;
   e. Differences between planned goals and current conditions;
   f. Origins of policies and approval process.

2. Determine management’s view and understanding of the planning and policy-making functions and their effects on the efficiency of operations.
3. Assess the system used by management and the BOD to ensure periodic review and revision of policies.

Planning

1. Determine if management has identified the type of organization it wants the bank to be in the future and how it plans to reach this goal, and whether this has received BOD approval.
2. Determine how the bank is organized by the BOD and how major decisions are made, taking into account:
   a. The direction provided by the BOD and management’s adherence to that direction;
   b. Involvement of Directors in the process;
   c. Whether management makes BOD presentations regarding new products, activities, etc.;
   d. How acquisitions, divestitures, and branching decisions are made;
   e. Whether the bank is independent or in a holding company;
   f. For holding company banks, assess the degree of autonomy in policy making, product development, market niche determination, advertising, market research, and entering or exiting a market.

3. Determine the techniques management uses in planning by considering:
   a. How goals, objectives, parameters, and assumptions are set and how they are communicated;
   b. How bank activities are evaluated;
   c. Action plans, including resource requirements;
   d. Involvement of directors, senior managers, and middle managers;
   e. Role of CEO.

4. Determine how management incorporates competitive factors when making plans, developing new products, or entering new markets, by considering:
   a. Management’s view of traditional and non-traditional competitors;
   b. Comparative advantages and disadvantages relative to competition.

5. Determine whether management identifies customers’ wants and needs before making plans, developing new products, or new markets, taking into account:
   a. Types of market research used, such as surveys, focus groups, outside services; and,
   b. Customer information files and profile studies.
6. Determine how management plans for new products. Does the management consider:
   
a. Due diligence/feasibility studies;
b. Financial projections – including when products will provide a return and when profitability of products is re-evaluated;
c. Risk/liability analyses;
d. Legal opinions;
e. Level of audit department involvement.

7. Determine whether management weighs the effect of its plans on its operations by taking into account:
   
a. Risk;
b. Regulatory requirements;
c. Financial condition of the bank;
d. Management ability and human resource demands;
e. Physical facilities;
f. Adequacy of MIS and operating systems to handle growth;
g. Current product mix and future product development;
h. Technological environment;
i. Public perception;
j. Sociological trends.

8. Determine whether goals and objectives have been established for the future and whether directors have approved them and managers are aware of them. Consider:
   
a. CEO’s/BOD vision of the future;
b. Bank’s mission (what it is or what the BOD would like it to be);
c. Qualitative as well as quantitative goals and objectives;
d. Participation of Directors and various levels of management;
e. How the information is communicated to those who need to know it.

9. Determine whether management has plans in place to achieve stated goals and objectives. Consider:
   
a. Whether action plans exist;
b. How action plans are implemented;
c. Accountability of management;
d. Resource requirements;
e. Communication.

10. Determine how management evaluates the validity of action plans to avoid conflicts among the bank’s business units. Consider:
a. Capacity of the bank to supply the needed resources (people, systems, facilities, advertising) to implement plans;
b. Availability of people, systems, facilities;
c. Accountability of managers to implement plans and achieve objectives;
d. CEO’s and BOD’s involvement.

11. Determine how plans are evaluated after implementation and whether plans are flexible enough to allow for contingencies or changes. Consider:
   a. Frequency and method of evaluation;
   b. CEO’s and BOD’s involvement;
   c. Accountability of managers to implement plans and achieve objectives;
   d. Whether the BOD reviews and approves plans;
   e. Systems in place to make changes;
   f. System in place to report on progress toward goals.

12. Determine whether the long-term (strategic) plan provides the framework for developing short-term (operating) plans.

13. Determine the mechanisms in place to ensure compatibility between the short-term and long-term plans by briefing or obtaining briefs from other examiners on the following:
   a. Annual financial plan/budget;
   b. Capital plan;
   c. Asset/liability plan;
   d. Marketing plan;
   e. Fixed asset plan;
   f. Any other plans.

14. Determine whether major decisions are made within the context of an overall institution plan.

**Personnel**

The examiner should confer with the EIC and other examiners in making conclusions regarding the adequacy of bank personnel or senior management.

**Objective 1**

Determine if the bank’s personnel activities are monitored by management and the BOD to ensure consistency with the goals of the bank and with any applicable laws, regulations, and policies.
**Procedures**

1. Determine how management and the BOD determine if the bank’s organizational structure accurately reflects the functional responsibility levels and lines of authority.

2. Determine if the bank has written job descriptions/responsibilities.

3. Determine how management ensures that job descriptions are clear and reflect assigned duties and responsibilities. Consider:
   a. The appropriateness of the required knowledge and skills;
   b. The basis for performance appraisals;
   c. The method used in developing or overseeing the job description process;
   d. The relationship to compensation program.

4. Determine how management ensures adequate staff at all levels. Consider:
   a. Recruitment methods;
   b. Performance standards;
   c. Training programs;
   d. Management succession plans;
   e. Compensation programs; and,
   f. Employee benefits.

5. Determine how management assesses employees’ performance.

6. Determine how the BOD assesses management’s performance.

7. Determine how management and the BOD ensure that salaries and benefits are equitable and competitive.

8. Determine the method management uses to promote an effective communication system. Consider systems such as:
   a. Staff meetings;
   b. Employee interviews;
   c. Employee handbooks, bulletins, etc.;
   d. All employee memoranda, e-mail, and other communications.
Controls

Objective 1

To ensure that management and the BOD have established effective control systems to fulfil their responsibilities and comply with laws and regulations.

Procedures:

1. Review the internal and external audit functions as they relate to management. Consider:
   a. Management and BOD review of insider transactions for compliance with laws, regulations, and policies;
   b. Management’s timely corrective action to address deficiencies noted by the regulatory examinations, external/internal audit, compliance, and/or internal review functions.

2. Determine the systems that management and the BOD use to control and monitor activities. Consider:
   a. Internal controls;
   b. Audit coverage;
   c. Asset quality reviews (including loan review);
   d. Risk management systems;
   e. Compliance management systems.

3. Determine the extent to which the BOD and management are involved in control systems. Consider:
   a. Adequacy, timeliness, and distribution of various reports;
   b. Periodic review to determine adherence with policies and procedures.

4. Determine if the bank has a BOD approved external/internal audit program. Evaluate the adequacy of the program. Consider:
   a. Independence of the auditors, including reporting lines;
   b. Qualification of auditors;
   c. Adequacy and appropriateness of audit program;
   d. Effectiveness of management’s response to, and correction of, identified audit concerns;
   e. Degree and effectiveness of audit committee oversight;
   f. External audit review of internal auditors;
   g. Results of prior supervisory activities.

5. Determine the process used by management to ensure that internal controls function properly. Consider:
a. Sources and accuracy of information;
b. Review of internal controls when changes in operations occur;
c. Roles in the development of new products or changes in operations;
d. Training of personnel to ensure that established policies and procedures are followed;
e. Efforts made by BOD and managers to correct deficiencies;
f. Relationship to internal audit.

6. Review systems established to monitor asset quality. Consider:
   a. Independence of personnel;
   b. Accuracy of problems identified and graded;
   c. Coverage of assets during a cycle;
   d. Effectiveness as an early warning system.

7. Review risk management systems. Consider:
   a. Concentrations of credit or other activities;
   b. Existing products and services;
   c. New products and services;
   d. Off-balance sheet activities; and,
   e. BOD involvement/understanding.

8. Review the compliance management program. Consider:
   a. Accountability;
   b. Areas covered and depth of coverage;
   c. Efforts to monitor and comply with new requirements, where necessary;
   d. Reporting;
   e. Correction of deficiencies;
   f. Qualifications of those involved;
   g. Regulatory requirements.

**Objective 2**

Determine if the MIS used by management and the BOD adequately measures the bank’s performance, assists in the decision-making process, and evaluates the effectiveness of existing policies, processes, and control mechanisms.

**Procedures**

1. Determine whether findings and conclusions from internal control systems provide appropriate, prompt, accurate, useful, and understandable information to managers and the BOD. Consider:
   a. Asset quality reviews (including loan review);
2. Determine what mechanisms are in place to ensure relevant, accurate, useful, and timely information.

3. Evaluate the dissemination of information among the bank’s management levels and among departments such as:
   a. Management and other directors;
   b. Management and staff;
   c. Bank and the holding company or affiliates.

4. Analyze the effectiveness of the MIS. Consider:
   a. Management’s knowledge and understanding of information systems;
   b. Use of data in the decision-making process.

Conclusions

Objective 1

Communicate examination findings and initiate appropriate corrective actions.

Procedures

1. In consultation with the EIC, provide conclusion of findings. Consider:
   a. Findings from all other areas under examination;
   b. Overall conclusion;
   c. Any recommendations to management;
   d. Violations of laws and regulations.

2. Determine the impact on the aggregate and direction of risk assessments for any applicable risks identified by performing the above procedures.

3. Determine, in consultation with the EIC, if the risks identified are significant enough to merit bringing them to the BOD’s attention in the ROE.

4. Discuss findings with management and agree conclusions regarding applicable risks. Considerations for discussions may include:
a. Overall conclusions;
b. Recommendations;
c. Violations of laws and regulations;
d. Deficiencies;
e. If applicable, commitment from management to correct violations of laws and/or matters requiring BOD attention.

5. As appropriate, prepare comments for inclusion in the ROE. Considerations for comments may include:

a. The frequency and effectiveness of meetings;
b. The effectiveness of BOD and management committees
c. Management’s role in establishing and implementing policy;
d. Any major inconsistencies in policy;
e. The quality of reports to management;
f. Violations of laws, regulations and rulings.
I. SENSITIVITY TO MARKET RISK EXAMINATION

1. Description

1.1. Conclusions:

- Sensitivity to Market Risk is rated as 1, 2, 3, 4, or 5.

1.2. Complete this section’s objectives to assign the sensitivity to market risk component rating. (Note: Market risk includes IRR, price risk, and foreign currency translation risk).

2. Assessment procedures

2.1. Minimum scope assessment

Objective 1

Determine the sensitivity to market risk component rating, the quantity of risk and the quality of risk management for IRR, price risk, and foreign currency translation risk.

Procedures

1. At the beginning of the supervisory activity, hold discussions with management covering actual or planned:

   a. Changes to the IRR policy (i.e. limit structures, risk measurement);
   b. Changes in the IRR management process;
   c. Material changes in the bank’s asset and liability structure;
   d. Changes in the investment portfolio’s impact on IRR; and,
   e. Changes in the level of price or foreign currency translation risk.

2. Discuss with the examiner responsible for completing the Audit and Internal Controls section of the minimum scope assessment and obtain for follow-up any significant findings on sensitivity to market risk.

3. Obtain and review the following information and documents, as appropriate for any matters on sensitivity to market risk:

   a. Minutes of the BOD and BOD sub-committees since the last examination;
b. Minutes of the Management committee since the last examination;
c. Prior ROE and related management and BOD responses;
d. Internal/External audit reports,
e. Minutes of the ALCO.

4. Determine the bank’s compliance with the relevant laws and regulations. Consider:
   a. Statutory Instruments;
   b. CBK rules and other issuances.

5. Determine whether there have been any significant changes in the bank’s activities, risk profile, or risk controls after consultation with examiners reviewing other areas. If not, conclude the sensitivity to market risk review by assigning an appropriate rating.

6. If significant changes in the bank’s activities, risk profile or risk controls have taken place, expand the scope of review to include additional objectives or procedures outlined under standard scope assessments.

2.2. Standard assessment

**Objective 1**

Determine the appropriateness and effectiveness of the risk management practices of the investment portfolio.

**Procedures**

1. Evaluate BOD and senior management oversight by considering:
   a. Procedures for approving major policies;
   b. The annual review of investment strategies and policies;
   c. The establishment of risk limits and procedures to ensure compliance;
   d. How well the BOD and management not involved directly or daily in investment activities understand those activities.

2. Review pre-purchase analyses of recent investments, and determine whether the analyses provide adequate information to understand the price sensitivity of the security.

3. Determine how well management monitors the investment portfolio by considering the following:
a. Whether significant risks in the bank’s investment activities are understood and properly reported;

b. The completion and documentation of stress testing on the types of securities, as required, in the bank’s investment policy or procedures;

c. Periodic evaluations of aggregate risk exposure and the overall performance of the investment portfolio.

**Interest Rate Risk**

**Objective 2**

Determine the quantity of IRR.

**Procedures**

1. Review the exposure to on- and off-balance sheet positions. Consider:

   a. The composition and risk characteristics of asset and liability maturity and cash flow structures;
   
   b. The volatility of the net interest margin over time;
   
   c. The level and impact of basis risk, yield curve risk, options risk, and re-pricing risk, as appropriate;
   
   d. The support provided by low-cost, stable non-maturity deposits.

2. Review the level and trend of earnings-at-risk as indicated by the bank’s risk measurement system.

3. Review the exposure to the bank’s economic value of equity (EVE). Consider the level and trend for significant volume of medium-term to longer term re-pricing risk and/or options related positions.

   Both earnings-at-risk and EVE should be measured under a minimum change in interest rates of plus or minus 200 basis points within a twelve month horizon.

4. Evaluate the on-going performance and effectiveness of any hedging strategies.

5. Determine the quantity of IRR, in consultation with the EIC and other appropriate examiners.

**Objective 3**

Determine the quality of risk management for IRR.
**Procedures:**

1. Obtain IRR-related information from the examiner assigned to review BOD minutes, and review minutes of any committee responsible for overseeing IRR.
2. Determine whether the BOD has approved policies establishing responsibility for the management of IRR, communicating risk tolerance, and providing sound guidelines for the management of IRR.
3. Assess the effectiveness of management and the BOD in overseeing IRR. Consider:
   a. The existence and reasonableness of BOD-approved limits for earnings and/or economic value-at-risk;
   b. Compliance with established risk limits;
   c. The adequacy of controls over the IRR management process;
   d. Management’s understanding of IRR and their ability to anticipate and respond appropriately to changes in interest rates or economic conditions.
4. Determine whether the risk management system used to measure earnings-at-risk is appropriate for the level and complexity of the bank’s exposure, and whether the major assumptions used to measure earnings-at-risk are reasonable.
5. Determine whether the risk management system used to measure economic value-at-risk is appropriate for the level and complexity of the bank’s exposure, and whether the major assumptions used to measure earnings-at-risk are reasonable.

   Note: Calculating the EVE in base-case and rising and falling an interest rate environment is the most effective risk measurement method for banks with significant longer term or options-related risk positions.
6. Determine whether the assumptions used in the risk measurement system are sufficiently documented.
7. Evaluate management’s ability and effectiveness in managing IRR. Consider:
   a. The level of understanding of the dynamics of IRR;
   b. The ability to respond to competitive pressures in financial and local markets;
   c. Whether a balanced presentation of risk and return are appropriately considered in asset/liability strategies;
   d. The ability to anticipate and respond to adverse or changing economic conditions and interest rates;
   e. Whether staff skills are appropriate for the level of complexity and risk.
8. Assess the timeliness, completeness, accuracy, and relevance of MIS. Coordinate this review with the examiners responsible for all functional areas of the examination to avoid duplication of effort. Findings should be communicated to the examiner reviewing IT.

9. Determine whether a competent, independent review process periodically evaluates the effectiveness of the IRR management system.

10. Assess the adequacy of the system of internal control over IRR, and from this assessment determine whether the risk management system to identify, measure, monitor, and control IRR is effective.

**Price Risk and Foreign Exchange Risk**

**Objective 4**

Determine the level of price risk or foreign currency exchange risk.

**Procedures**

1. Determine from the bank’s trading activities, investments denominated in foreign currencies or any other activities that subject the bank to price or foreign exchange risk:
   a. The quantity of risks in relation to the bank capital and earnings;
   b. The quality of risk management systems including:
      • the ability or expertise of bank management;
      • the adequacy of risk management systems.

**Objective 5**

Determine the significance of Market risk to the bank’s capital and earnings.

**Procedures**

1. In consultation with the EIC and other examiners, decide whether the aggregate level or direction of any risk noted during the review of sensitivity to market risk has had, or is expected to have, an adverse impact on capital or earnings.

**Objective 6**

Communicate examination findings and initiate appropriate corrective actions.
Procedures:

1. In discussion with the EIC, provide preliminary conclusions about:

   a. The quantity of risk;

   b. The quality of risk management;

   c. The aggregate level and direction of interest rate, price, foreign currency exchange, or any other applicable risk; and,

   d. Supervisory strategy recommendations.

2. In consultation with the EIC and other examiners, identify and communicate to other examiners, as appropriate, any conclusions and findings from the sensitivity to market risk review that are relevant to other areas being reviewed.

3. Determine, in consultation with the EIC, if the risks identified are significant enough to merit bringing them to the BOD’s attention in the ROE.

4. Discuss findings with management and agree conclusions regarding the quality of both the audit function and internal control. Considerations for discussions may include:

   a. Overall conclusions;

   b. Recommendations;

   c. Deficiencies; and,

   d. If applicable, commitment from management to correct violations of laws and/or matters requiring BOD attention.

5. Using the results of the foregoing procedures and any other applicable examination findings, prepare comments for inclusion in the ROE.
1. Description

1.1. Conclusions:
- Audit is assessed by rating its quality as Weak, Acceptable or Strong.
- Internal controls are assessed by rating the systems collectively as Weak, Acceptable or Strong.

1.2. Complete this section’s objectives to assess the quality of the bank’s overall audit and system of internal controls. In completing these assessments, the examiner should consult the EIC and other appropriate examiners. Consider the following factors when assessing the quality of audit and internal controls:
- BOD and management oversight;
- Systems and processes;
- Reporting;
- Staffing.

2. Assessment procedures

2.1. Minimum scope assessment

Objective 1
Determine the quality of audit and internal control systems, and consider the potential impact of these findings on the bank’s risk assessment.

Procedures:

1. At the beginning of the examination, discuss with the bank’s management the following:
   a. The audit or internal control systems in place and planned changes, if any;
   b. Changes in the policies and procedures governing the audit and internal controls function, if any;
   c. Changes in BOD audit committee, audit department’s structure, management and staffing;
   d. The audit plan;
   e. How the management supervises internal control activities;
   f. Any significant changes in business strategy or activities that could affect internal control;
   g. Any other external factors that could affect or may have affected the internal control function.
2. Review the previous ROE and other correspondence to identify audit and internal control issues that require follow-up.

3. Obtain and review the following information and documents:
   a. Audit and Internal Control policy and procedures manual;
   b. Outsourcing contracts/ agreement (if the function is outsourced);
   c. Detailed listing of duties and responsibilities of the internal auditor;
   d. Minutes of the BOD Audit Committee and applicable BOD minutes since the last examination;
   e. Audit plans for the period under review, both internal and external;
   f. Internal and external audit reports for the period under review, including the management letter and any management assertions and independent public accountant validations on internal control;
   g. Audit staff tenure, turnover, and vacancies; and,
   h. Information of operational losses sustained during the past 12 months.

4. Discuss with, and obtain from examiners responsible for completing other areas any significant audit and internal control findings that require follow up.

5. Assess compliance with laws and other prudential requirements, and share the findings with the examiner reviewing Management.

6. In consultation with the EIC, determine whether there have been any significant changes in the bank’s activities, risk profile, or risk controls, and/or whether the above review of the audit and internal controls raises substantive issues. If not, conclude the earnings review by assigning an appropriate rating.

7. If significant changes in the bank’s activities, risk profile or risk controls have taken place, and/or if the review of the audit and internal controls raises substantive issues, expand the scope of review to include additional objectives or procedures outlined under the standard assessment.

2.2. Standard assessment

2.2.1 Internal and External Audits

**BOD and Committee Oversight**

**Objective 1**

Determine the overall quality of BOD and Committee oversight of the bank’s audit function.
Procedures

In addition to procedures 1, 2, 3, and 4 under minimum scope assessment, perform the following additional procedures:

1. Determine whether the BOD or its audit committee does the following:
   a. Reviews and approves audit strategies, policies, programs (including laws and regulations compliance), and organizational structure, including selection/termination and compensation of external auditors or outsourced internal audit vendors;
   b. Establishes schedules and agendas for regular meetings with internal and external auditors;
   c. Supervises the audit functions directly to ensure that internal and external auditors are independent and objective in their findings;
   d. Works with internal and external auditors to ensure that the bank has comprehensive audit coverage to meet the risks and demands posed by its current and planned activities;
   e. Has significant input into hiring senior internal audit personnel, setting their compensation, and evaluating the internal audit manager’s performance;
   f. Reviews and approves annual audit plans and schedules (and any changes thereto) for both internal and external audits;
   g. Retains auditors who are fully qualified to audit the kinds of activities in which the bank is engaged;
   h. Meets with supervisors, at least once each supervisory cycle, to discuss the findings of the CBK’s review of the bank’s audit functions;
   i. Monitors, tracks, and when necessary, provides discipline to ensure effective and timely response by management to correct control weaknesses and violations of laws/regulations noted in internal or external audit reports or in ROE.

2. Has the BOD established an audit committee? If so, are committee members:
   a. Independent of bank management?
   b. All outside directors or at least a majority of outside directors?

3. Review documentation pertaining to management’s assessment of financial reporting controls and its own investigation. Consider whether:
   a. Management maintains records of its review;
   b. Results of the review are discussed with the audit committee;
   c. Management’s assessment of financial reporting controls and compliance with relevant laws are consistent with findings of the internal and external auditors, as well as supervisory examination findings.
Internal Audit

**Objective 2**

Determine the adequacy of the BOD and management oversight of the bank’s internal audit function.

**Procedures**

1. Determine whether the BOD, commensurate with the bank’s activities and risk profile, has established an internal audit program that:
   a. Adequately monitors internal control systems;
   b. Is independent and objective;
   c. Is staffed by qualified persons;
   d. Adequately tests and reviews information systems;
   e. Adequately documents tests, findings, and corrective actions;
   f. Verifies and reviews management actions addressing material weaknesses;
   g. Requires the BOD or audit committee to review the internal audit systems’ effectiveness.

2. Determine whether the bank’s internal audit program includes:
   a. An audit charter or mission statement that sets forth the audit department’s purpose, objectives, organization, authority, and responsibilities
   b. An audit plan that addresses goals, schedules, staffing budget, reporting, and, if applicable, financial budgets;
   c. A policies and procedures manual for audit work programs and, if applicable, risk-based auditing/risk assessments and outsourcing of internal audit work; and,
   d. A program for professional development and training of audit staff, including orientation and in-house and external training opportunities.

3. Review BOD or audit committee minutes, or summaries thereof, and audit information packages submitted to the BOD or audit committee to determine whether:
   a. The BOD or its audit committee has formally approved the internal audit program and annual audit plan and schedule;
   b. Internal audit reports and other audit-related information submitted regularly to the BOD or its audit committee are sufficient for effective monitoring of internal audit’s performance and progress toward meeting approved audit plans and schedules;
c. Internal audit program and annual/schedule are periodically reviewed and updated by the internal audit department, with changes reported to the BOD or audit committee;

d. Progress has been made toward completing the audit program or schedule and the BOD or audit committee has approved significant audit program/schedule changes;

e. Reasonable consideration is given to staffing, compensation, and training requirements;

f. Management does not unduly participate in or dominate the directors’ or audit committee supervision of the internal audit function.

4. Determine whether the internal auditor reports directly to the BOD or to an appropriate audit committee.

5. Determine whether management takes appropriate and timely action on internal audit findings and recommendations and whether it reports the action to the BOD or its audit committee.

6. Determine whether the activities of the internal audit function are consistent with the long-range goals of the institution and are responsive to its internal control needs.

7. If the bank has a quality assurance program, evaluate the adequacy and effectiveness of the program by determining whether:

   a. Standards and criteria have been established for evaluating the performance of the internal audit function;

   b. Quality assurance is conducted in the following manner:

      - continuous supervision by internal audit manager;

      - periodic internal reviews by a team or individual from the internal audit staff;

      - external reviews by qualified persons independent of the bank.

   c. A formal report, written or oral, is generated and to whom the report is directed (i.e. internal audit manager, senior management, or BOD or its audit committee);

   d. Quality assurance reviews are conducted regularly.

8. Review policies and procedures pertaining to the bank’s internal audit function, including, as applicable, those related to risk-based audits, and outsourcing of internal audit activities. Consider whether written policies:

   a. Are adequately reviewed and approved by the BOD or its audit committee annually;

   b. Properly reflect authorities and responsibilities established by the audit charter or mission statement;

   c. Establish proper scope and frequency for internal audits by considering:

      - Purpose and objectives of audits;

      - Control and risk assessments;

      - Audit cycles; and,
d. Establish adequate guidelines for human resources involved in the audit function. Consider:
   - Organization and independence of the audit department;
   - Responsibilities of audit staff;
   - Job standards and qualifications;
   - Training and development; and,
   - Performance evaluations.

Objective 3

Evaluate the independence and competence of those who manage and perform internal audit functions, whether or not they are bank employees.

Procedures

1. Assess the educational and professional experience of the internal auditor and staff by reviewing resumes of the internal auditor/manager, new internal audit staff, or those recently promoted to senior levels, noting:
   a. The level of education attained;
   b. Significant work experience, especially in the bank auditing arena, including specialized areas;
   c. Any certification as a certified bank auditor, certified internal auditor, certified information systems auditor, or certified public accountant;
   d. Membership in professional associations.

2. Review job descriptions for various audit positions, and discuss with the audit manager the following:
   a. Educational and experience requirements for various audit positions, including those for specialized areas;
   b. Programs of continuing education and professional development, including in financial services and auditing technology and specialized areas; and,
   c. Supervision of the auditors.

3. If deemed appropriate, review performance evaluations of the audit manager and audit staff. Determine how identified strengths and weaknesses in supervisory, technical, or interpersonal skills or abilities affect the quality of the internal audit function.
4. Assess audit personnel turnover and vacancies, focusing on the reasons for turnover/vacancies and their effect on the internal auditing function.

5. Determine whether there are any reporting lines or operational duties assigned to the auditor that are incompatible with the internal audit function. If reporting lines or operational duties exist, determine whether independence is compromised or whether the situation is appropriately controlled and monitored. Independence may be compromised if the auditor:
   a. Reports to a senior management official, i.e., CFO, or similar officer;
   b. Has dual reporting, functionally to the audit committee on audit issues and to senior management for administrative matters;
   c. Has responsibilities for operating a system of internal controls or actually performs operational duties or activities.

6. Determine whether there is any auditor relationship, such as family ties with other bank employees, which is incompatible with the internal audit function.

7. Determine whether there are any restrictions placed on the internal audit program, including scheduling or budgetary restraints imposed by management.

**Objective 4**

Determine the adequacy and the reliability of work performed by the internal auditors.

**Procedures:**

1. Involve examiners responsible for other areas to obtain and review copies of:
   a. The internal audit reports;
   b. The internal audit work papers.

   Note: In most situations, reviewing the work papers that document the procedures and testing performed by the internal auditor should be sufficient to substantiate conclusions about the quality and reliability of the internal audit function.

2. Review the bank’s internal audit program for completeness and compliance with prior BOD or audit committee approval.

3. Analyze the internal auditor’s evaluation of departmental internal controls, and compare it with the control evaluations done by examiners.

4. Review internal audit reports to determine whether they are adequate and prepared in accordance with established audit policy. Consider the reports’ distribution, time frames, content, and follow-ups.
5. Assess the most recent audit plan and determine whether adequate coverage and internal risk assessment is provided for all areas of operation.

6. If the auditor uses sampling in control testing, asset verification, transactional testing, administrative audits, etc., determine whether the audit work program addresses:
   a. Objectives of testing;
   b. Procedures to meet objectives;
   c. Populations subject to sampling;
   d. Method of sampling;
   e. Selection and justification of a representative sample sufficient to support conclusions;
   f. Evaluation of results and documentation of conclusions.

7. Evaluate the scope of the internal auditor’s work as it relates to the bank’s size, the nature and extent of activities, and the bank’s risk profile.

**Outsourced Internal Audit Function**

**Objective 5**

If the internal audit function, or any portion of it, is outsourced to outside vendors, determine the effectiveness and reliability of the outsourced internal auditing work.

**Procedures:**

1. Obtain and review the following documents:
   a. Outsourced internal audit arrangement contracts or engagement letters;
   b. Outsourced internal audit reports;
   c. Outsourced audit policies, if any.

2. Review the outsourcing arrangement contract/engagement letter between the vendor and bank and determine whether the contract/letter adequately:
   a. Defines the expectations and responsibilities under the contract for both parties;
   b. Sets the scope, frequency, and fees to be paid for work to be performed by the outside vendor;
   c. Describes responsibilities for providing and receiving information, such as the type and frequency of vendor reporting to the bank’s audit manager, senior management, and audit committee or BOD about the results and status of work;
   d. Establishes protocol for changing the terms of the engagement, especially for expansion of audit work if significant issues arise, as well as stipulations for default and termination of the contract;
e. States that the internal audit reports are the property of the bank and specifies ownership of internal audit work papers. If the vendor retains ownership of the work papers, the contract should stipulate that the bank will be provided copies of related work papers it deems necessary, and that bank-authorized employees will have reasonable and timely access to vendor work papers;

f. Notes that the vendor’s internal audit activities are subject to CBK review and examiners will be granted full and timely access to all related outsourced internal audit reports, audit programs, audit work papers, and memorandums and correspondence prepared by the outsourced vendor;

g. Specifies the locations of and how long the vendor will retain outsourced internal audit reports and related work papers. If the work papers are in electronic format, the agreement should also address vendor maintenance of proprietary software to facilitate bank or examiner reviews of work papers;

h. Establishes processes for resolving disputes, as well as indemnification provisions for determining who bears the cost of consequential damages arising from errors, omissions, and negligence;

i. States that the vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to a member of bank management or a bank employee.

3. Determine, through discussions with bank management or review of applicable documentation, whether the BOD or audit committee performed sufficient due diligence to satisfy themselves of the vendor’s competence and objectivity prior to entering into the outsourcing arrangement.

4. Arrange a meeting with the vendor and discuss the vendor’s outsourced internal audit program. Consider:

a. Vendor’s understanding of the bank’s risk profile and business;

b. Vendor’s sampling techniques for testing internal controls;

c. Vendor’s training program for its audit staff;

d. Communication with and reporting to the bank’s BOD, audit committee, and management;

e. Whether the vendor’s audit procedures are customized for each client or are generic;

f. Vendor’s methods for reviewing internal controls;

g. Methods used to structure vendor contracts;

h. How the vendor ensures independence/coordination with external audit activities;

i. Work paper documentation standards.
5. Review outsourced internal audit reports issued and a sample of outsourced internal audit papers to determine their adequacy and preparation in accordance with the audit program and the outsourcing agreement.

6. Determine whether the outsourcing arrangement maintains or improves the quality of the internal audit function and the institution’s internal controls. Consider:
   a. Scope and quality of internal audit work;
   b. Overall internal control structure;
   c. Audit and control evaluations;
   d. Adherence with engagement terms;
   e. Consistency with audit policies, audit plans, and BOD and management expectations;
   f. Vendor notification of any process, staffing, or other changes affecting contracted work.

7. Determine whether the scope of outsourced audit work is revised appropriately when the bank’s environment, activities, risk exposures, or systems change significantly.

8. Determine, by discussion with bank management and the vendor, whether the bank and its vendor have discussed and determined that applicable independence standards are being met.

9. If there is sufficient reason to question the independence, objectivity, or competence of the vendor, discuss the situations with the EIC, the BOD or audit committee, and the vendor to clarify or resolve the issues.

10. If the examination findings indicate that the vendor’s work cannot be relied upon, discuss the assessment with the BOD, management, and the affected party before finalizing the ROE.

**Objective 6**

Determine whether the internal risk analysis processes are adequate for the bank’s size, the nature and extent of its financial services activities, and its risk profile.

**Procedures:**

1. Determine whether the bank has appropriate standards and processes for risk-based auditing and internal risk assessments. Such standards and processes should:
   a. Identify businesses, product lines, services, or functions and the activities and compliance issues within those areas that should be audited;
b. Develop risk profiles that identify and define the risk and control factors to assess and the risk management and control structures for each business, product line, service, or function;

c. Establish the process for grading or assessing risk factors for business units, departments, products, or functions, including time frames;

d. Describe how the process is used to set audit plans, resource allocations, scopes of audits, and audit cycle frequency;

e. Implement audit plans through planning, execution, reporting, and follow-up.

2. Select a sample of the bank’s auditable entities and determine the reasonableness of the internal risk analysis decision, including application of any risk models used.

3. Determine whether audit frequencies are reasonable and are being met.

4. If applicable, determine the quality and effectiveness of internal audit’s ongoing monitoring of the bank’s business operations.

**External Audit**

**Objective 1**

Determine the adequacy of BOD oversight of the external audit function.

**Procedures**

1. Review BOD or audit committee minutes, or summaries thereof, as well as audit information packages submitted to the BOD or audit committee, and determine whether the following is noted:

   a. Formal approval of the external audit program and schedule, or reasons supporting any decision to forgo an external audit program;

   b. The monitoring of external audit reports to determine whether the approved external audit program and schedule is being followed;

   c. The results of any vote taken regarding external audit;

   d. Confirmation that the audit committee reviews external audit reports with management and the external auditors in a timely manner;

   e. Discussion of the external auditor’s independence.

2. Trace the distribution of the external audit reports to determine whether the external auditor reports to the BOD or audit committee.

3. Determine whether management responds appropriately and in a timely manner to external audit findings and recommendations.
4. Determine whether the activities of the external audit function are consistent with the institution’s long-range goals and are responsive to its internal control and financial reporting needs.

5. Determine whether the BOD or its audit committee, at least annually, identifies the major risk areas in the institution’s activities and assesses the extent of external auditing needed for each area.

6. Determine that the scope of the external auditors’ services goes beyond statutory audits to include other special audits such as IT, internal control, credit, and compliance audits.

7. Review the engagement letter and external audit plans to determine whether the external audit program is appropriate given the bank’s size, the nature and extent of its activities and operations, and its risk profile.

8. Read engagement letters covering audit activities or management advisory services (i.e., non-audit or consulting) performed by external auditors. Determine whether the letters address the following:
   a. Purpose, scope, and fees of the audit or consulting services;
   b. Period to be covered by the audit or consulting services;
   c. Reports expected to be rendered;
   d. Any limits on the scope of the audit or consulting services;
   e. Examiner access to audit work papers.

**Objective 2**

Review the independence and objectivity of those who provide the external audit function.

**Procedures**

1. Determine whether the BOD or its audit committee and the external auditor have discussed any financial, employment, business, or non-audit service relationships that may compromise or appear to compromise the external auditor’s independence.

2. Determine whether the bank has recently changed external auditors and discuss with appropriate management the reasons for the change. Particular attention should be given to disagreements between the external auditor and management about the appropriate accounting principles applicable to specific transactions or matters.

2.2.2 Quality of Internal Control

**Control Environment**

**Objective 1**
Determine whether the institution’s control environment embodies the principles of strong internal control

**Procedures**

1. Assess the effectiveness of the control environment. Consider:
   a. The integrity, ethics, and competence of personnel;
   b. The organization structure of the bank;
   c. Management’s philosophy and operating style;
   d. External influences affecting operations and practices;
   e. Personnel policies and practices;
   f. The attention and direction provided by the BOD and its committees, especially the audit or risk management committees.

2. Determine whether the BOD periodically reviews policies and procedures to ensure that proper risk assessment and control processes are instituted.
3. Determine whether there is an audit or other control system in place to periodically test and monitor compliance with internal control policies/procedures and to report to the BOD instances of non-compliance.
4. Determine whether MIS provides the BOD the information it needs to make informed and timely decisions.
5. Determine whether the BOD or management communicates policies regarding the importance of internal control and appropriate conduct to all employees.
6. Determine whether codes of conduct or ethics policies exist. Consider whether:
   a. Audit or other control systems exist to periodically test for compliance with codes of conduct or ethics policies;
   b. Audit or other control system personnel routinely review policies and training regarding ethics or codes of conduct.

**Risk Assessment**

**Objective 2**

Determine whether the bank’s risk assessment system allows the BOD and management to plan for and respond to existing and emerging risks in the bank’s activities.

**Procedures:**

1. Determine whether the BOD and management involve audit personnel or other internal control experts in the risk assessment and risk evaluation process.
2. Determine whether the risk assessment/evaluation process involves sufficient staff members who are competent, knowledgeable, and provided with adequate resources.

3. Determine whether the BOD and management discuss and appropriately evaluate risks and consider control issues during the pre-planning stages for new products and activities.

4. Determine whether audit personnel or other internal control experts are involved when the bank is developing new products and activities.

5. Determine whether the BOD and management consider and appropriately address technology issues.

6. Determine the adequacy of blanket bond or other risk insurance coverage in relation to the bank’s risk profile.

Control Activities

Objective 3

Determine whether the BOD and senior management have established effective control activities in all lines of business.

Procedures

1. Determine whether policies and procedures exist to ensure that decisions are made with appropriate approvals and authorizations for transactions and activities.

2. Determine whether processes exist to ensure that:
   
   a. Performance and integrity of each function are independently checked and verified;
   
   b. Accounts are reconciled continually, independently, and in a timely manner and that outstanding items, both on- and off-balance sheet, are resolved and cleared;
   
   c. Policy overrides are minimal and exceptions are reported to management; and,
   
   d. Employees in sensitive positions or risk-taking activities do not have absolute control over areas, e.g. segregation or rotation of duties, vacation requirements, dual controls or joint custody over access to assets.

3. Determine whether reporting lines within a business or functional area provide sufficient independence of the control function.

4. Determine whether operating practices conflict with established areas of responsibility and control.
5. Determine whether internal audit or other control review functions are sufficiently independent. Consider:

   a. Where the function reports, administratively, within the bank;
   b. To whom, or to what level, the function reports the results of work performed;
   c. Whether practices conform to established standards; and,
   d. Whether management unduly influences the timeliness of risk analysis and control processes.

6. Determine whether the BOD and senior management have established adequate procedures for ensuring compliance with applicable laws and regulations. Consider:

   a. The frequency of testing and reporting for compliance with laws and regulations;
   b. Whether appropriate attention and follow-up are given to violations of laws and regulations.

**Accounting, Information, and Communication Systems**

**Objective 4**

Determine whether the institution’s accounting, information, and communication systems ensure that risk-taking activities are within policy guidelines and that the systems are adequately tested and reviewed.

**Procedures**

1. Assess the adequacy of accounting systems by determining whether:

   a. The systems properly identify, assemble, analyze, classify, record, and report the institution’s transactions in accordance with International Financial Reporting Standards (IFRS);
   b. The systems account for all the assets and liabilities involved in transactions.

2. Assess the adequacy of MIS by determining:

   a. The type, number, and depth of reports generated for operational, financial, managerial, and compliance-related activities;
   b. Whether reports are sufficient to properly run and control the institution; and,
   c. Whether reports access to information systems is properly restricted.
3. Assess the adequacy of communication systems by determining whether:
   a. Significant information is imparted throughout the institution (top-down and vice versa) ensuring that personnel understand their roles in control systems, the interaction of their activities with others, and their accountability for the activities they conduct; and,
   b. Significant information is imparted to external parties such as regulators, shareholders, and customers.

4. Assess how frequently and thoroughly the accounting, information, and communication systems are verified.

Self Assessment and Monitoring

Objective 5

Determine whether the BOD and senior management properly oversee internal controls, control reviews, and audit findings.

Procedures:

1. Determine whether the BOD or a designated BOD committee has reviews management’s actions to deal with material control weaknesses and verifies that corrective actions are objective and adequate.
2. Determine the frequency and comprehensiveness of reports to the BOD or BOD committee and senior management.
3. Determine the adequacy of the BOD’s or its committee’s review of audit and other control functions.
4. Assess the adequacy and independence of the audit or other control review function.
5. Determine whether management responses to audit or other control review findings are fully documented and tracked for adequate follow-up.

Objective 6

Communicate examination findings and initiate appropriate corrective action.

Procedures

1. In consultation with the EIC, provide conclusions of findings. Consider:
   a. Findings from all other areas under examination;
   b. Overall conclusion; and,
   c. Any recommendations to management.

2. Determine how the quality of both the audit function and internal control affects on the aggregate level and direction of risk assessments for any applicable risks identified by performing the above procedures.
3. Determine in consultation with the EIC, if the risks identified are significant enough to merit bringing them to the BOD’s attention in the ROE.

4. Discuss findings with management and agree conclusions regarding the quality of both the audit function and internal control. Considerations for discussions may include:

   a. Overall conclusions;
   b. Recommendations;
   c. Deficiencies;
   d. If applicable, commitment from management to correct violations of laws and/or matters requiring BOD’s attention.

5. As appropriate, prepare comments for inclusion in the report of examination. Considerations should include:

   **Quality of Audit Function**

   a. The ability and effectiveness of the bank’s audit processes to assess and detect risk in bank operations;
   b. The adequacy of audit policies, procedures, programs, and the BOD’s or audit committee’s oversight;
   c. Whether internal and external auditors and outsourced vendors operate in conformance with established policies, standards, rules, and regulations;
   d. The adequacy and availability of information about, or generated by, the audit function and provided to management and the BOD or its audit committee;
   e. Significant areas of weaknesses identified by internal or external audits and management’s progress in correcting those weaknesses;
   f. Internal and external audit report findings not acted upon by management as well as any other concerns or recommendations resulting from the review of audit functions;
   g. Recommended corrective actions, if applicable, and management’s commitments.

   **Quality of Internal Controls**

   a. Whether the internal control environment poses actual or potential undue risk to the bank’s financial performance;
   b. The adequacy of internal control policies, procedures, and programs to control and limit risk in bank operations;
   c. Whether personnel operate in conformance with established policies, and if not, the causes and consequences;
d. The adequacy of information on the internal control function received by the BOD or its committees and management;

e. Significant areas of control weakness identified by internal or external audits or other control reviews and the BOD’s and management’s progress in addressing those weaknesses;

f. Audit or other control review report findings not acted upon by management, as well as any other concerns or recommendations resulting from the review of internal control functions; and,

g. Recommended corrective actions, if applicable, and management’s commitments.
K. EXAMINATION OF INFORMATION TECHNOLOGY

1. Description

2. Assessment procedures

2.1. Minimum scope assessment

Objective 1
Assess the management of the field of information technology.

Procedures

1. Assess the policies, procedures and standards of the information technology and information security.
   a. Verify the availability of policies, procedures, standards, etc.;
   b. Verify the approval level of policies, procedures, standards, etc.;
   c. Verify the period of approval and review of policies, procedures, standards, etc.;
   d. Verify minutes of the board’s meetings when policies, procedures, standards, etc., where approved;
   e. Assess the adequacy and applicability of policies, procedures, standards, etc.;

2. Assess whether the board of directors and senior management are informed of developments and risks in the field of the information technology.

3. Analyze the organization chart of the information technology department and assess the level of coverage with adequate staff in certain IT fields.

Objective 2
Assess the adequacy of the main banking system.

Procedures:

1. Verify the validity and conditions of the contract for license and maintenance of the main banking system with the company which provided the service;
2. Verify availability of guidelines for use of the adequate and detailed system (manual) for proper use of the system by the users.

3. Verify the availability of system with audit reports or adequate logo for monitoring the actions respectively modifications and deletions including all the necessary data to identify the person who committed the change and the person who authorized the change, time of the change, values prior and after the change, etc.

**Objective 3**

Assess the adequacy of physical security level of information technology devices.

**Procedures:**

1. Assess the adequacy of hardware devices that are in use by the institution.
   a. Availability of devices and operating systems in use;
   b. The level of use and laptop owners;
   c. Availability with adequate and functional antivirus;
   d. The methods used for encrypting;

2. Verify the security level in the server room:
   a. Adequacy of monitoring the access to the server room;
   b. The number and level of staff authorized to access the server room;
   c. Adequate protection from the risks of the external environment in case of direct exposure;
   d. Availability of surveillance cameras, the monitoring centre location and duration of storage of recordings in the server room space;
   e. Availability of motion detectors (alarm), smoke detectors in case of fire, humidity detectors and temperature sensors;
   f. Backup devices for power supply and keeping the temperature constant;
   g. Adequate and functional devices for automatic fire suppression;
   h. Identification of entries/exits in the server room by external contractors for servicing purposes;
   i. Verify the availability of adequate procedure for the use of the card/spare key by responsible persons in cases of emergency use.

3. Verify if it is conducted regular maintenance of the database of the main banking system in a location other than server rooms, in a secure place with limited access only by authorized persons. The method of transporting data of the main banking system in case of extraction outside the bank should be conducted in protected and encrypted manner in order to restrict access to these data.
2.2. Standard scope assessment

Objective 1

Assess the information technology and information security policies.

Procedures:

1. Assess the policies, procedures and standards of the information technology.
   a. Verify the availability of policies, procedures, standards, etc.;
   b. Verify the approval level of policies, procedures, standards, etc.;
   c. Verify the period of approval and review of policies, procedures, standards, etc.;
   d. Verify minutes of the meetings of BOD and other bodies of the bank’s when policies, procedures, standards, etc., were approved;
   e. Assess the adequacy and applicability of policies, procedures, standards, etc.;

2. Assess the policies, procedures and standards of the information technology:
   a. Verify the availability of policies, procedures, standards, etc.;
   b. Verify the approval level of policies, procedures, standards, etc.;
   c. Verify the period of approval and review of policies, procedures, standards, etc.;
   d. Verify minutes of the board’s meetings when policies, procedures, standards, etc., were approved;
   e. Assess the adequacy and applicability of policies, procedures, standards, etc.;

3. Assess the institution's strategy for the field of information technology and if the IT functions have effective management processes to implement the strategy.

Objective 2

Assess management of the field of information technology.

Procedures

1. Assess whether the BOD and senior management are informed about developments and risks in the field of information technology.
2. Analyze the organization chart of the information technology department and assess the level of coverage with adequate staff in certain IT fields.

3. Review the job descriptions of the staff of the information technology department and their professional preparation.

4. Review the reports of the information technology department for reporting to management by analyzing these data:
   a. Time interval of reporting;
   b. The reported level of information, respectively the involvement of all issues in the reports;
   c. Accuracy and diligence of reported information;
   d. Managerial level reported;

5. Assess the mood and functioning of committees for information technology and security.
   a. Review the period of holding regular meetings of committees;
   b. Review the composition and participation of committee members in the meetings;
   c. Review the content of minutes of committee meetings held since the last examination;

6. Assess the quality and adequacy of internal audits on information technology by analyzing the findings in the audit reports on information technology.

**Objective 3**

Assess the adequacy of hardware and software used by the institution.

*Procedures:*

1. Assess the adequacy of hardware devices that are in use by the institution.
   a. Availability of devices and operating systems in use;
   b. The level of use and laptop owners;
   c. Availability with adequate and functional antivirus;
   d. The methods used for encryption;

2. Assess the adequacy of software in use by the institution.
   a. The purpose of software use;
   b. Relevant licenses for software use;
   c. Validation of software and license expiration date;
d. Validity and terms of contracts for software maintenance by the respective companies where applicable (e.g. the contract for maintenance of the main banking software);

3. Analyze the list of external contracting companies and services that these companies provide for the institution as well as their location.
4. Verify the organizational structure of the internal and external communications network of the institution.
5. Verify the number of internet providers with whom the institution has an agreement to provide internet services, respectively whether the institution has in availability other internet service providers that are ready to be activated in case of malfunction of one of the internet providers.

**Objective 4**

Assess the adequacy of the level of physical security of information technology devices.

**Procedures:**

1. Verify the level of security in the server room.
   a. Adequacy of monitoring the access in the server room;
   b. The number and level of the staff authorized to access the server room;
   c. Adequate protection from the external environment risks in case of direct exposure;
   d. Availability of surveillance cameras, the monitoring centre location and duration of storage of recordings in the server room space;
   e. Availability of motion detectors (alarm), smoke detectors in case of fire, humidity detectors and temperature sensors;
   f. Backup devices for power supply and maintaining constant temperature;
   g. Adequate and functional devices for automatic fire suppression;
   h. Identification of entries/exits in the server room from external contractors for servicing purposes;
   i. Verify the availability of adequate procedure for the use of the card/spare key by responsible persons in cases of emergency use.

**Objective 5**

Assess the adequacy of the main banking system.

**Procedures**
1. Verify the validity and terms of the contract for license and maintenance of the main banking system with the company which provided the service;

2. Verify availability of guidelines on the use of adequate and detailed system (manual) for proper use of the system by the users.

3. Assess whether management of the system is done by the adequate level, respectively by the adequate roles and that the staff responsible for managing possesses adequate knowledge of use.

4. Verify the availability of system with audit reports or adequate logs for monitoring the actions respectively modifications and deletions including all the data necessary to identify the person who committed the change and the person who authorized the change, the time of the change, values prior and after the change, etc.

5. Verify if the users passwords to access the main banking system are stored and encrypted adequately in order not to allow anyone access to read them.

6. Verify if there is a regular maintenance of the database of the main banking system in an outdoor location from the server rooms, in a secure place with limited access only by authorized persons. The method of transporting data of the main banking system in case of extraction outside the bank should be conducted in protected and encrypted manner to restrict access to these data.

7. Verify the access of the staff to data in the main banking system depending on positions they have, especially on roles with administrative rights and roles with rights to modify and delete data in the system.

8. Assess the time period necessary for the responsible company for maintenance of the system, for answering and fixing problems and errors which are reported to the company for development or regulating.

**Objective 6**

Assess the control level and security of users' access.

**Procedures**

1. Verify the request and authorization process for creating a user, modifying the rights of a user and passive role of a user.

2. Verify the applied methods and periodic intervals of periodic review of accesses from all users.

3. Verify the active access, double accesses and the respective rights in the main banking system of active employees of the institution.

4. Verify the eventual active accesses of employees outside working schedule or who should not have access but still continue to have access to the main banking system.

5. Verify the active access and double access in the institution's network (domain) of the active employees of institution and passive employees who are not working and should not continue to have active access.
**Objective 7**

Assess the level of controls to protect information from unauthorized access, disclosure and modifications.

**Procedures**

1. Verify whether the institution possesses a staff responsible for information security. Whether it operates independently from the information technology department and whether it reports periodically to the management regarding information security in the institution.
2. Analyze and assess the procedures for reporting incidents of information security.
3. Verify the implementation of information security safeguards through categorization of documents and access controls on relevant documents according to categorization. Verify availability of appropriate procedures for categorization of documents.
4. Verify the implementation of the confidentiality agreement forms applied for the entire staff of the institution.
   a. Verify internet access restrictions in terms of permitted/banned websites.
   b. Verify the list of staff with access to the internet and the level of access permitted;
   c. Verify the list of categorization of websites that are permitted/limited;
5. Verify access restrictions to ports for the use of peripheral devices, respectively, analyze the list of staff with approved access by verifying positions and the reasons for granting such accesses.
6. Verify the procedure of transmitting passwords to relevant staff, safeguards for maintaining confidentiality, complexity level of the password allowed for use and the time interval until the expiration of the password.

**Objective 8**

Assess the commitment and willingness of the institution regarding business continuity.

**Procedures**

1. Assess the ability of backup systems and the presence of business continuity plans to minimize the possibility of termination of business.
2. Assess the policy/plan for business continuity.
   a. Verify availability of policy/plan for business continuity;
b. Verify the level of approval of the document;
c. Verify the period of document approval and review;
d. Assess the adequacy and implementation of the document;

3. Verify appointment and approval of the team responsible for business continuity, as well as persons adjutant to the team.

4. Verify the realization of periodical tests for business continuity and assess the adequacy, intervals between the tests and the results of these tests.

5. Verify realization of training for business continuity and assess the adequacy and involvement of all staff in these training.

**Objective 9**

Assess the adequacy of the physical security level of information technology devices at the backup location for recovery from disasters.

**Procedures**

1. Verify the security level in the server room in the backup location for recovery from disasters.

   a. The adequacy of monitoring accesses in the server room;
   b. The number and level of staff authorized to access the server room;
   c. Adequate protection from the risks of external environment in case of direct exposure;
   d. Availability of surveillance cameras, the location of monitoring centre and duration of storage of recordings in the server room space;
   e. Availability of motion detectors (alarm), smoke detectors in case of fire, humidity detectors and temperature sensors;
   f. Backup devices for power supply and maintaining constant temperature;
   g. Adequate and functional devices for automatic fire suppression;
   h. Identification of entries/exits in the server room from external contractors for servicing purposes;
   i. Verify on what basis is transferred the copy of the data from the primary location to the backup location.
   j. Verify the availability of adequate procedure for the use of the card/spare key by responsible persons in emergency cases.

**Objective 10**

Assess the safety level of electronic banking (e-banking).
**Procedures**

1. Verify the agreement for maintenance of electronic banking system with the company that provides the service and location of the company.
2. Verify the sufficiency and adequacy of the institution staff for the management of electronic banking respectively customer management.
3. Assess the level of security controls for the verification and authentication of client, confidentiality and integrity of the data, prevention and detection of intrusion.
4. Verify the institution’s website for electronic banking services to verify the organization, structure, operation and field of electronic banking activities.
5. Verify plans of recovery in case of a disaster of technology and business of electronic banking and functioning of services during interruption of services.
6. Identify any applied or planned change in activities and electronic banking services.
L. CONCLUSION OF EXAMINATION

1.1. Conclusions:

- The bank’s rating is 1, 2, 3, 4, or 5.
- The bank’s overall risk profile is Low, Moderate, or High.

1.2. To conclude the supervisory cycle, examiners will meet all objectives under this section, regardless of the bank’s risk designation.

Objective 1

Determine and update the bank’s composite rating and other regulatory ratings, as appropriate.

Procedures

1. Consider findings from the following areas:

   a. Audit and internal control;
   b. Capital Adequacy;
   c. Asset Quality;
   d. Management Capability;
   e. Earnings quality and quantity;
   f. Liquidity adequacy;
   g. Market Sensitivity; and,
   h. Compliance with laws and regulations.

2. Ensure that the evaluation of all component ratings has considered the following:

   a. Bank’s size;
   b. Bank’s sophistication;
   c. Nature and complexity of the bank’s activities; and,
   d. Bank’s risk profile

Objective 2

Determine the risk profile using the risk assessment system.
**Procedures**

1. Draw conclusions about quantity of risk, quality of risk management, net risk, and the direction of net risk for each of the five risk categories.
2. Using the assessments made on the five individual risks, the EIC should establish the institution’s overall risk rating. The overall risk profile is not an average, but a combination of the assessments of all the individual risks. In establishing the overall risk profile, the EIC should use judgment to weigh all the risks by relative importance of each risk.

**Objective 3**

Finalize the examination.

**Procedures**

1. Preparation of the summary report regarding the concluding meeting of examination shall be prepared by the responsible examiner based on inputs received from the examiners. Each examiner shall prepare and submit its part (work papers) to the responsible examiner for a particular field which after the review are signed together with the examiner and the final version and then the same are submitted to the responsible examiner of the examination;

2. Submission of the summary report to RAD – means the review of summary report before the concluding meeting of the bank;

3. Meeting with RAD regarding the final assessment – includes the discussion at department level in relation to preliminary assessment of the bank. At this meeting participate the Director and heads of the divisions of the relevant field, as well as the staff of RAD, senior examiners and other examiners invited by the director;

4. Concluding meeting of the examination – means the meeting with the senior management of the examined bank. In this meeting participate: the director of the department, heads of the divisions of the relevant field as well as the responsible examiner;

5. Submission of the draft reports from the team to responsible examiner – means the preparation phase of the draft report of examination where each examiner responsible for the examined field shall submit its part to the responsible examiner;

6. Completion of the engagement of the team except (responsible examiner) – after the submission and signing of work papers to responsible examiner, shall end each engagement of the examiners’ team appointed previously;

7. Preparation and submission of the draft report from the responsible examiner – means the submission of the draft report to the head of the division of relevant field;
8. Review of the draft report of examination – means analysing, commenting and reviewing the draft report of examination by the head of the division of relevant field;
9. Review and submission of draft report of examination – after reviewing the draft-report of examination by the head of the division of relevant field, the draft report in question shall be submitted to the director of department for review;
10. Discussion with the deputy governor for financial supervision regarding the findings – means discussion of draft report by presenting the main findings of the report to the deputy governor for financial supervision;
11. Submission of the draft report to the bank for review – after its detailed review, the draft report is submitted to the bank for comments;
12. Receiving the comments from the bank – presents the period when the bank exercises the right to comment the findings of the draft report as well as to submit the comments to CBK;
13. Finalization and submission of final report of examination – includes the period of careful review of comments from banks as well as finalization of examination report. However, if the bank is estimated to be subject of remedial measures, then the bank is provided with a detailed statement by describing the facts and the law supporting the existence of violation and the bank will be provided with a full opportunity to ensure its facts and arguments as to why the punishment shall not be imposed. In appeal cases, the bank shall submit the same according to Regulation on Procedures for Imposing Administrative Penalties.
14. If based on the overall assessment of the last examination the bank is assessed with grade 3, 4 or 5, then the finalization and signing of the examination report shall be accompanied by a decision of the Executive Board of CBK.

Objective 4

Follow up and monitoring

Procedures:

1. The responsible examiner shall continuously follow-up the status of fulfilment of recommendations of examination, core knowledge, risk profile as well as the relevant decisions (if any). The frequency of monitoring the status shall correspond to the terms outlined in the examination report, including relevant decisions.
2. In addition to what was mentioned above, the responsible examiners for the bank shall compile a summary report for the bank on quarterly basis including also the status of fulfilment of recommendations of examination, basic knowledge, risk profile as well as relevant decisions (if any).
### Appendix VIII. Examination (program) agenda

<table>
<thead>
<tr>
<th>Description</th>
<th>Responsible</th>
<th>Duration (in workdays)</th>
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</thead>
<tbody>
<tr>
<td><strong>COMPLETE EXAMINATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PERIOD PRIOR EXAMINATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Assignment of examination team</td>
<td>UDMV, DDMB</td>
<td>1 workday</td>
</tr>
<tr>
<td>2. Request to Supervisory Authority of the parent bank and assignment of the (potential) staff joining the examination team</td>
<td>DDMB</td>
<td>-</td>
</tr>
<tr>
<td>3. Preliminary information for examination</td>
<td>DDMB</td>
<td>-</td>
</tr>
<tr>
<td>4. Preparation of Core Knowledge</td>
<td>EP</td>
<td>10 workdays</td>
</tr>
<tr>
<td>5. Request to EAFSD in relation with economic environment in Kosovo and Turkey</td>
<td>DDMB</td>
<td>1 workday</td>
</tr>
<tr>
<td>6. Request to RAD in relation with the stress-test and relevant reports</td>
<td>EP</td>
<td>1 workday</td>
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<tr>
<td>7. Submission of request as above by the EAFSD</td>
<td>DSFAE</td>
<td>1 workday</td>
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<tr>
<td>8. Preparation of risk profile from on-site point of view</td>
<td>EP</td>
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<tr>
<td>9. Preparation and submission of stress-test and relevant reports from RAD</td>
<td>DRA</td>
<td>2 workdays</td>
</tr>
<tr>
<td>10. Preparation of scope memo</td>
<td>EP</td>
<td>10 workdays</td>
</tr>
<tr>
<td>11. Assignment of specific tasks for the examination staff</td>
<td>EP, UDMV</td>
<td>2 ditë punë</td>
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<tr>
<td>12. Preparation of letter request and notice letter</td>
<td>EP</td>
<td>2 workdays</td>
</tr>
<tr>
<td>13. Submission of letter request and notice letter</td>
<td>DDMB</td>
<td>1 workday</td>
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<tr>
<td>14. Preparations for the commencement of examination</td>
<td>Examination team</td>
<td>15 work days</td>
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<tr>
<td>15. Meeting with the examination team</td>
<td>DDMB, UDMV</td>
<td>1 work day</td>
</tr>
<tr>
<td>16. Logistics issues of examination</td>
<td>EP, UDMV</td>
<td>2 work days</td>
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<tr>
<td><strong>EXAMINATION PERIOD</strong></td>
<td></td>
<td></td>
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<tr>
<td>17. Opening meeting for examination</td>
<td>DDMB, UDMV, EP</td>
<td>1 work day</td>
</tr>
<tr>
<td>18. Examination period</td>
<td>Examination team</td>
<td>25 - 30 work days</td>
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<tr>
<td>19. Regular meetings with the responsible examiner</td>
<td>DDMB, UDMV</td>
<td>1 meeting per week</td>
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<tr>
<td><strong>PERIOD AFTER EXAMINATION</strong></td>
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<td></td>
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<tr>
<td>20. Preparation of summary report regarding the concluding meeting of examination</td>
<td>EP</td>
<td>5 work days</td>
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<tr>
<td>21. Meeting with RAD regarding final assessment</td>
<td>EP</td>
<td>1 work day</td>
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<tr>
<td>22. Concluding meeting of examination</td>
<td>Examination team</td>
<td>1 work days</td>
</tr>
<tr>
<td>No.</td>
<td>Activity Description</td>
<td>Responsible Examiners</td>
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<td>Submission of draft reports from the team to responsible examiner</td>
<td>DDBM, UDMV, EP</td>
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<td>24</td>
<td>Completion of the engagement of the team except for the responsible examiner</td>
<td>Examination team</td>
</tr>
<tr>
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<td>26</td>
<td>Review and submission of draft report of examination</td>
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<td>Discussion with the deputy governor regarding the findings</td>
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<td>Submission of draft report to the bank for review</td>
<td>DDBM</td>
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<td>Comments received by the bank</td>
<td>DDBM, UDMV, EP</td>
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<tr>
<td>30</td>
<td>Submission of draft report to the bank for review</td>
<td>DDBM</td>
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<td>Banks</td>
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Appendix IX. Report of Examination Format

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   3.3. Liquidity Risk
   3.4. Sensitivity to market risk
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   3.6. Internal controls
   3.7. Operational risk
   3.8. Capital adequacy
   3.9. Earnings
   3.10. Violations of laws and regulations
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4. Issues requiring attention
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   5.2. CAMELS rating table
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9. Signature of members of the Board of Directors and Chief Executive Officer
Report of Examination Contents

This ROE consists of six major sections as indicated below.

1. Background Information
2. Final comments of examination
3. Risk assessment and summary of classification
4. Issues requiring attention
5. Summary of risk assessments and CAMELS
6. Violations of laws and regulations
7. Compliance management
8. Appendices
9. Signature of members of the Board of Directors and Chief Executive Officer

Brief description of each section of the report is as follows:

1. Background Information
   Contains: Information on the bank, examination scope and concluding meeting of the examination. Contains: information on the bank including, licensing date of the bank, ownership structure, shareholder capital and other information for the bank. Examination scope includes the procedures which will be used during the examination for each risk and CAMELS component, as well as description of the reasons for their use. Moreover, includes also other issues of the bank activity. At the concluding meeting, the examination results are communicated to the management of the bank and the participants in this meeting shall be mentioned by the CBK and the bank.

2. Final comments of the examination
   Contains: issued requiring attention, by listing them;

3. Risk assessment and summary of classification
   Contains: conclusions of the examination in relation to the risk assessment and CAMELS rating, violations of laws and regulations and compliance management; Contains: management/governance, credit risks and quality of assets, liquidity risk, sensitivity to market risk, internal audit, internal controls, operational risk, capital adequacy, earnings, violations of laws and regulations, compliance management.

4. Issues requiring attention
   Contains: issues requiring attention which are listed by the board of directors and management to ensure correction within the prescribed time limits;
   Contains: listing of the issue, recommendation and time limit.

5. Summary of risk assessments and CAMELS
Contains: risk matrix and description of risk assessment, table of CAMELS rating by describing each of its component, internal audit, internal controls and information technology.

The examiners shall present the assessment report of the quantity for each risk, quality of risk management, overall level of risk and risk management assigned for 12 next months. The examiners shall also present the reasons for their conclusions regarding the quantity of each type of risk, quality of risk management, overall level of risk and risk management assigned. The examiners shall at least comment for the following risks: credit risk, liquidity risk, market risk and operational risk.

Summary of assessment of CAMELS components:

The examiners shall assess the CAMELS components in tabular form for current examination and the last two examinations.

The examiners shall assess each CAMELS component and provide their reasons for such assessment. The examiners shall provide at least the following information related to each component:

1. Capital adequacy

The examiners shall report on their conclusions regarding the bank capital whether the same meets the minimum regulatory requirements. In these conclusions are considered the following:

   a) Adequacy of bank capital, including the impact of assets quality, off-balance items and earnings;
   b) Trends and changes at the level and structure of capital;
   c) Comparison of capital and assets growth;
   d) Adequacy of provisions for losses from loans and leasing and its effects in cases of insufficient capital;
   e) Policy on dividend and its impact on capital;
   f) Ability/willingness of management and shareholders to maintain a sufficient level of capital;
   g) Any additional capital needed to comply with the regulatory requirements.

2. Quality of assets

The examiners shall report their conclusions regarding:

   a) Adequacy of lending standards, sound practices of administering the loans and practices for identifying the risk;
b) Level, distribution, difficulties and trend of the problem: classified, non-accrual, rescheduled, past-due and non-performing assets on balance and off-balance transactions;
c) Adequacy of provisions for loan losses from leasing as well as reserves of other assets;
d) Credit risk deriving from, or deducted from off-balance transactions such as unfunded commitments, credit derivatives, standby letters of credit.
e) Diversification and quality of loan portfolio and investments;
f) The range of securities activities and exposure to parties in trading activities;
g) Existence of assets concentration;
h) Adequacy of loan and policies for investments, procedures and practices;
i) Adequacy of internal controls, internal review of loans and management information system; and
j) Volume and nature of exceptions to the loan documentation.

3. Management

The examiners shall report their conclusions as follows:

a) The ability of management to determine the risks associated with the financial services and economic situation;
b) The ability of the board of directors and management to identify, measure and control or mitigate the risks associated with the operations of the bank;
c) The ability of the board of directors and management to plan and address negative changes and manage the risks as a consequence of volatile economic conditions as well as to introduce new types of activities and products;
d) The ability of the board of directors and management to ensure a sufficient level of capital, quality of assets, incomes and liquidity;
e) Compliance with the laws and bank regulations as well as with financial services; policies and internal procedures;
f) Effectiveness of organizational structure;
g) Adequacy and applicability of business plans (strategic, short-term) and their implementation;
h) Adequacy and implementation of human resources policy;
i) Effectiveness and internal controls including their implementation and compliance;
j) Accuracy, time limit and effectiveness of management information system and risk monitoring systems which are suitable to the size, complexity and risk profile of the bank;
k) Independence of internal and external audit functions, scope, frequency and adequacy of audit controls including comments on how the management addresses the audit recommendations;
l) Management actions which result in exposing the bank to higher risks (self-lending, misuse of authority, conflict of interest); and
m) Management responses to previous regulatory recommendations, compliance and readiness to undertake corrective actions.
4. Earnings

The examiners shall report their conclusions as follows:

a) Level and trends of earnings;
b) Quality and structure of earnings;
c) Adequacy of provisions for possible losses;
d) Level and trend of main types of incomes and expenditures;
e) Weakness in the unpaid items, securities transactions (listed according to market), types of activities with higher risks and unconventional sources of income;
f) Control of incomes and expenditures, including variance analysis of budget and the current one;
g) Weaknesses in expensive funds;
h) Corrections in the balance sheet to ensure accurate report of incomes and expenditures;
i) Impact on potential complaints in bank arising from judicial disputes; and,
j) Incomes and expenditures items which shall be corrected in compliance with the examination results.

5. Liquidity

The examiners shall report their conclusions as follows:

a) Trends, levels and sources of liquid assets (i.e. assets that can be easily converted into cash);
b) Money markets and other financing sources;
c) Types of financing sources for on-balance and off-balance sheets;
d) Stability of funds withdrawn in relation to the sensitivity level of the bank’s expensive and volatile financing resources (interbank funds etc);
e) Ability and competences of management to determine, measure, monitor, control and mitigate the bank’s liquidity position;
f) Adequacy of management information system, reserve plan and compliance with the liquidity requirements, including the adequate and timely decision-making in the field of funds management;
g) Potential impact to other liquidity risks; and,
h) Compliance with the policies and procedures of the bank itself for fund management.

6. Sensitivity to market risk

The examiners shall report their conclusions on:

a) Adequacy of policies, practices and procedures of the bank for the interest rate and foreign exchange risks;
b) Adequacy of measurement systems used from the bank to assess the interest rate and foreign exchange risks;
c) Existence and effectiveness of the limits determined to control changes of possible risks compared to the size of the bank assets, level of activities and capital adequacy;

d) Effectiveness of internal controls, including delegation of authorities as well as appropriate division of duties; and

e) Adequacy of periodic reviews and rationale of internal and/or external audit in relation to the accuracy, structure and assumptions used in the process of identifying the risks, as well as their role in ensuring the compliance of the bank with the prescribed limits and regulatory requirements.

6. Violations of laws and regulations
Contains: listing of legal violations of the bank identified during the examination;

7. Compliance management
Contains: listing of the bank’s non-compliance with internal policies, procedures and its internal documents identified during the examination;

8. Appendixes
Contains: various information to support remarks and conclusions of the examination. Contains: Balance sheet, off-balance sheet, income statement, core capital - report (structure of capital), risk-weighted assets, classification of assets and required reserves, summary of classified assets, summary of past-due assets, assets/items that are subject of classification, concentrations, changes in reserves for loan losses, report on the liquid assets.

9. Signature of members of the board of directors and chief executive officer
Contains: signature of members of the board of directors and chief executive officer in relation with the examination report;
M. DETERMINATION OF AUDIT FREQUENCY

Banks are classified in five separate zones according to their final levels: White zone, green zone, yellow zone, orange zone, red zone. Each zone shall enable audit cycle, audit intensity of the relevant bank, attitude of the CBK to the relevant bank as well as application methods to be determined.

An audit cycle is composed of periods from 6 to 24 months which shall be determined according to the zones they have been divided into.

**White Zone:** Banks having final level of “1” are included in white zone and these banks require rarer audit activities. Audit cycle is determined to be 24 months in minimum. Low level audit activity is deemed adequate.

**Green Zone:** Banks having final level of “2” are included in green zone and these banks are subject to on-site audit activities once in 18 months at least.

**Yellow Zone:** Banks having final level of “3” are included in yellow zone. Medium-level on-site audit is applied to these banks. Audit cycle is determined to be 12 months in minimum.

**Orange Zone:** Banks having final level of “4” are included in orange zone. Intensive audit is applied to these banks. Audit cycle is determined to be 6 months in minimum. A correcting program shall be applied in the bank for improving the controls.

**Red Zone:** Banks having final level of “5” are included in red zone. Intensive audit is applied to these banks. Audit cycle is determined to be between 0 to 6 months. Immediate correcting action is required for improving the risk profile of the bank.

<table>
<thead>
<tr>
<th>Final Note</th>
<th>Zone</th>
<th>Audit Frequency</th>
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<tbody>
<tr>
<td>1</td>
<td>White Zone</td>
<td>Minimum 24 MONTHS</td>
</tr>
<tr>
<td>2</td>
<td>Green Zone</td>
<td>Minimum 18 MONTHS</td>
</tr>
<tr>
<td>3</td>
<td>Yellow Zone</td>
<td>Minimum 12 MONTHS</td>
</tr>
<tr>
<td>4</td>
<td>Orange Zone</td>
<td>Minimum 6 MONTHS</td>
</tr>
<tr>
<td>5</td>
<td>Red Zone</td>
<td>0-6 MONTHS</td>
</tr>
</tbody>
</table>
N. CONSOLIDATED SUPERVISION

A simple financial institution engaged in a single activity is relatively straightforward to supervise. However, financial institutions expand, diversify, make investments, and form subsidiaries. They also form partnerships and acquire other companies. They open operations in other companies, engage in licensing and franchising, and are acquired themselves. With so many permutations, supervisors are in need to gather information necessary to gain a proper view of complex business structure. Appropriately consolidated financial information provides the foundation for supervisors to evaluate the financial strength, risks, and profitability of the consolidated organization and apply key prudential regulations on a consolidated basis. However, consolidated supervision is much broader in scope than accounting consolidation concepts.

As banks undertake a variety of different business activities in different types of operating entities and across many countries, it is important that a banking group is supervised on a consolidated basis given that risks can emerge from any part of the group. The scope of consolidated supervision is meant to be comprehensive and should cover non-banking entities within the group, as well as entities that are beyond the scope of accounting consolidation. In addition, it must cover the parent company of the bank, as well as any affiliated companies of the parent company.

For the effectiveness of consolidated supervision, cooperation with relevant authorities and implementation of prudential requirements are needed.

When examining the banking group, the supervisor needs to be assured that entities within the banking group and within the broader financial and mixed conglomerate are:

- a source of support (for instance, management and capital support);
- not a source of weakness;
- the group should be in a position to provide capital and liquidity supports to the bank/banking group if so required, instead of a possible drain on the capital and liquidity resources of the bank/banking group;
- weaknesses of companies within the group that could threaten the bank/banking group position are identified.

First, the supervisor should understand the overall structure of the banking group (bank and banks’ affiliates) and the wider group (parent company, parent’s affiliates). To understand this:

- Understand bank’s relationship with other group entities;
- Understand bank’s relationship with other group entities;
• Understand the activities of all material parts of the group;
• Supervise foreign activities of domestic banks and require closing of foreign offices; or to impose limitations on activities if:
  o oversight by management or host is not adequate (relative to risks);
  o cannot gain access to required information;
  o these pose risks to the bank or banking group.
• Review activities of parent companies & their affiliates to determine impact on the safety & soundness of the bank & banking group.
• Cooperate and coordinate with other supervisory agencies/units (domestic and cross border).

There could be different types of group structures. The scope of the consolidated supervision will differ based on different group structures.

_Type A Group Structure (The main distinctive feature of this type is that the parent company is regulated/supervised by the CBK)_

The supervisor should examine the Type A group structure on a consolidated basis which include:

• Assessment of quantitative measures (Banking returns on large exposures, capital adequacy and liquidity on a consolidated basis and external auditors’ confirming the accuracy of banking returns and the adequacy of the return compilation system are the main information sources): These measure are Capital adequacy, Liquidity, Large exposures and Connected parties.

• Performing qualitative assessment on group’s organization structure, corporate governance, and quality of management, risk management systems and internal controls. Information sources upon request, that will help assessing the associated risks are: organization chart of the group, group risk management structure and policies, audited consolidated financial statements of the group or other relevant group companies, risk management reports at the group level (e.g. on large exposures, connected exposures, capital adequacy, liquidity risk and other major risks), other management information reports at group level.
In order to assess the cross sector and cross border operations of the group, policies formed within the CBK and MOUs signed with foreign authorities are utilized. The aims are; setting out the respective roles and responsibilities of the regulators, minimizing duplication of regulatory efforts, closing gaps in regulatory boundaries and promoting mutual assistance and the exchange of information.

Type B Group Structure (The main distinctive feature of this type is that the parent company is regulated/supervised outside of Kosovo)

If the banking group in Kosovo is the part of international banking groups (Type B Group Structure), the ultimate consolidated supervision of the relevant financial group vests with the home banking regulators (Still the regulated entity by the CBK and its subsidiaries are subject to principles given above for Type A group structure).

Type C Group Structure (The main distinctive feature of this type is parent is non-regulated/non-supervised outside or inside of Kosovo)
However, if the parent is an unregulated holding company (Type C Group Structure), this holding company and sister companies within the group should be subject to more detailed review. The supervisor assess if the “controller” remains fit and proper.

Factors to be taken into consideration in assessing the suitability of a holding company include: Group structure, quality of group corporate governance and management oversight, Risk profile, overall financial strength of the group and Risk management and internal controls.

1. **Group structure**: sufficient transparent legal, managerial, and operational structures for the supervisor to ascertain:
   - Major subsidiaries or affiliates, principal place of business, and location of major management of the major business lines;
   - The way in which the group is managed and controlled at high level, and where relevant, the ways cross-border operations are managed;
   - Major lines of accountability within the group;
   - Key corporate, financial, and other linkages between the AI and other group members;
   - The level to which the corporate structure of the group may affect the supervision and regulation of the banking group;
   - The extent to which the parents and affiliates for the banking group are supervised by other domestic regulators (within or out of the CBK) or overseas regulatory authorities.

2. **Quality of group corporate governance and management oversight**:
   - Composition of the board and audit committee of the relevant holding company;
   - Sufficient knowledge and expertise of the board and senior management of the controller;
• Oversight of significant transactions with related parties (particularly those involving the banking group);

• The degree of influence exercised by the controller on the conduct of the affairs of the banking group and commensurate with which;

• The existence within the controller of the knowledge, experience, competence, soundness of judgement and diligence required for running the banking group

• Any records of criminal convictions, breach of statutory or regulatory enactments, non-compliance with non-statutory codes or reprimand or disqualification by professional or regulatory bodies.

3. **Risk Profile: The principal risks inherent in the group:**

• Major operations and overall business strategies
• Major risk-taking entities or business units
• Trends and major activities that may significantly change the risk profile
• Potential risk posed by other group companies to the banking group, in particular:
  - Intra-group transactions of the banking group need to be conducted on an arm’s length basis;
  - Ability to withstand contagion from the group e.g. ability of the banking group to raise capital and solicit liquidity from the market.

4. **Overall financial strength of the group:**

• Capability to provide continuing support to the banking group in case of need:
  - Whether the controller is state-owned;
  - Profitability and liquidity of the group;
  - Capital position;
  - Strategic direction;
  - Any matters that may impair the financial strength of the group.

• Letter of comfort from the controllers to confirm their policy to provide capital and/or liquidity support to the banking group in case of need.

5. **Adequacy of risk management and internal controls:**

• Involvement of the board and senior management at group level in risk management;
The way in which risk management function is organised and conducted on a group-wide basis;
Capital management process of the group;
Liquidity management process of the group;
Group’s internal controls mechanism, in particular the independence and competence of internal auditors.

Controller is expected to submit group-level information to the CBK on an annual basis, or more frequently if necessary. Group-level information include:

- Group organization chart;
- Overview of group risk management framework;
- Audited consolidated financial statements and other relevant financial information of the holding company;
- The audited financial statements of other relevant group companies.
  Controller should notify the CBK promptly of any developments at group level that may affect the position of the bank/banking group. This includes:
  - Any matter that may significantly impair the capital and / or liquidity of the group;
  - Significant group-wide financial exposures and connected lending
  - Ngarkesën e krijuar mbi asetet e grupit që do të sjellë vlerën totale të të gjitha ngarkesave të rëndësishme;
  - Charge created over the assets of the group that will bring the aggregate value of all charges significant;
  - Acquisition, establishment, disposal or closure of any subsidiary of significant importance;
  - Significant change in the principal activities of any company within the group;
  - Change in the chief executive or the directors of the controller.

Supervisors’ assessment on the group will be reflected to ROE. The main aim is to ensure effective group-wide supervision and other institutions within the group are a source of support and not a source of weakness for the bank/banking group.
O. CAMELS RATING GUIDELINES

The following sections contain the definitions of composite ratings, and the descriptions and definitions for the five component ratings.

1. Composite Ratings

Composite ratings are based on a careful evaluation of a bank’s managerial, operational, financial, and compliance performance. The six key components used to assess a bank’s financial condition and operations are: Capital Adequacy, Asset Quality, Management capability, Earnings quantity and quality, adequacy of Liquidity and Sensitivity to Market Risk. The rating scale ranges from 1 to 5 as defined below:

1.1. Composite Rating: 1

Banks in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the BOD and management. These banks are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These banks are in substantial compliance with laws and regulations. As a result, these banks exhibit the strongest performance and risk management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

1.2. Composite Rating: 2

Banks in this group are fundamentally sound. For a bank to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the BOD’s and management’s capabilities and willingness to correct. These banks are stable and are capable of withstanding business fluctuations. These banks are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution’s size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.
1.3. Composite Rating: 3

Banks in this group exhibit some degree of supervisory concern in one or more of the component areas. These banks exhibit a combination of weaknesses that may range from moderately severe to unsatisfactory. However, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Banks in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those rated a composite 1 or 2. Additionally, these banks may be in significant non-compliance with laws and regulations. Risk management practices may be less than satisfactory relative to the bank’s size, complexity, and risk profile. These banks require more than normal supervision, which may include formal or informal enforcement actions. However, failure appears unlikely, given the overall strength and financial capacity of these banks.

A “3” or worse rating will prompt CBK supervisory action - a BOD resolution, a memorandum of understanding, a written agreement or a cease and desist order.

1.4. Composite Rating: 4

Banks in this group generally exhibit unsafe and unsound practices or conditions, and have one or more of their components rated 5. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the BOD and management. Banks in this group generally are not capable of withstanding business fluctuations. They may be in significant non-compliance with laws and regulations. Risk management practices are generally unacceptable relative to the bank’s size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

1.5. Composite Rating: 5

Banks in this group exhibit extremely unsafe and unsound practices or conditions, a critically deficient performance, and often contain inadequate risk management practices relative to the bank’s size, complexity, and risk profile. Banks with this composite rating are of the greatest supervisory concern. The volume and severity of problems are beyond management’s ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the bank to be viable. On-going supervisory attention is necessary. Banks in this group pose a significant risk and failure is highly probable.
2. Component Ratings

The Early Warning System (EWS) ratings of Capital, Asset Quality, Earnings, and Liquidity (CAEL) will be used as preliminary ratings when assessing each CAMELS component. Final ratings for each component will be determined after taking into account other evaluation factors as listed under each component.

Each of the component rating descriptions is divided into two sections, a list of the principal evaluation factors that relate to that component; and a brief description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The listing of evaluation factors for each component rating is in no particular order of importance.

2.1. Capital Adequacy

The capital adequacy of a bank is rated based upon, but not limited to, an assessment of the following evaluation factors:

1) The level and quality of capital and the overall financial condition of the institution;
2) The ability of management to address emerging needs for additional capital;
3) The nature, trend, and volume of problem assets, and the adequacy of allowances for probable losses and other valuation reserves;
4) Balance sheet composition, including the nature and amount of intangible assets, concentration risk, and risks associated with non-traditional activities;
5) Risk exposure represented by off-balance sheet activities;
6) The quality and strength of earnings, and the reasonableness of dividends;
7) Prospects and plans for growth, as well as past experience in managing growth; and,
8) Access to capital markets and other sources of capital, including support provided by a parent company.

Capital Adequacy Ratings:

Rating 1: indicates a strong capital level relative to the bank’s risk profile.
Rating 2: indicates a satisfactory capital level relative to the bank’s risk profile.
Rating 3: indicates a less than satisfactory level of capital that does not fully support the bank’s risk profile. The rating indicates a need for
improvement, even if the bank’s capital level exceeds minimum regulatory and statutory requirements.

**Rating 4:** indicates a deficient level of capital. In light of the bank’s risk profile, viability of the bank may be threatened. Assistance from shareholders or other external sources of financial support may be required.

**Rating 5:** indicates a critically deficient level of capital such that the bank’s viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

### 2.2. Asset Quality

The asset quality of a bank is rated based upon, but not limited to, an assessment of the following evaluation factors:

1. The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
2. The level, distribution, severity, and trend of problem, classified, non-accrual, restructured, delinquent, and non-performing assets for both on-balance and off-balance sheet transactions.
3. The adequacy of the allowance for probable loan and lease losses and other asset valuation reserves.
4. The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit.
5. The diversification and quality of the loan and investment portfolios.
6. The extent of securities underwriting activities and exposure to counterparties in trading activities.
7. The existence of asset concentrations.
8. The adequacy of loan and investment policies, procedures, and practices.
9. The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
10. The adequacy of internal controls and MIS.
11. The volume and nature of credit documentation exceptions.

**Asset Quality Ratings:**

**Rating 1:** indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management’s abilities. Asset quality in such banks is of minimal supervisory concern.
Rating 2: indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management’s abilities.

Rating 3: indicates that asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

Rating 4: is assigned to banks with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the bank to potential losses that, if left unchecked, may threaten its viability.

Rating 5: represents critically deficient asset quality or credit administration practices that present an imminent threat to the bank’s viability.

2.3. Management
The capability and performance of the BOD and management is rated based upon, but not limited to, an assessment of the following evaluation factors:

1) The level and quality of oversight and support of all institution activities by the BOD and management.
2) The ability of the BOD and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
3) The formulation of appropriate policies and procedures guidelines to guide the bank’s business activities.
4) The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
5) The accuracy, timeliness, and effectiveness of MIS and risk monitoring systems appropriate for the bank’s size, complexity, and risk profile.
6) The adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting, safeguard assets, and ensure compliance with laws, regulations and internal policies.
7) Responsiveness to recommendations from auditors and supervisory authorities.
8) Management succession.
9) The extent that the BOD and management is affected by, or susceptible to, dominant influence or concentration of authority.
10) Reasonableness of compensation policies and avoidance of self-dealing.
11) Demonstrated willingness to serve the financial services needs of the community.

**Management Ratings:**

**Rating 1:** indicates strong performance by the BOD and management, and strong risk management practices relative to the bank’s size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled or mitigated. The BOD and management have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

**Rating 2:** indicates satisfactory BOD and management performance, and risk management practices relative to the bank’s size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the bank and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled or mitigated.

**Rating 3:** indicates BOD and management performance that need improvement or risk management practices that are less than satisfactory given the nature of the bank’s activities. The capabilities of the BOD or management may be insufficient for the type, size, or condition of the bank. Problems and significant risks may be inadequately identified, measured, monitored, controlled or mitigated.

**Rating 4:** indicates deficient BOD and management performance or risk management practices that are inadequate considering the nature of an institution’s activities. The bank’s level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, controlled or mitigated and require immediate action by the BOD and management to preserve the soundness of the bank. Replacing or strengthening the BOD or management may be necessary.

**Rating 5:** indicates critically deficient BOD and management performance or risk management practices. The BOD and management have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, controlled or mitigated and now threaten the continued viability of the bank. Replacing or strengthening the BOD or management is necessary.
2.4. Earnings

The rating of the bank’s earnings is based upon, but not limited to, an assessment of the following evaluation factors:

1) The level, trends and stability of earnings.
2) The ability of the bank to provide for adequate capital through retained earnings.
3) The quality and sources of earnings.
4) The level of expenses in relation to operations.
5) The adequacy of the budgeting systems, forecasting processes, and MIS in general.
6) The adequacy of provisions to maintain the ALLL.
7) The earnings exposure to market risk.

**Earnings Ratings:**

**Rating 1:** indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

**Rating 2:** indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the bank’s level of earnings is adequate in view of the assessment factors listed above.

**Rating 3:** indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accumulation of capital and allowance levels in relation to the bank’s overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

**Rating 4:** indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Banks so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.
Risk-based bank supervision manual

Rating 5: indicates earnings that are critically deficient. Earnings rated 5 indicate losses that represent a distinct threat to a bank’s viability through the erosion of capital.

2.5. Liquidity

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

1) The adequacy of liquidity sources compared to present and future needs and the ability of the bank to meet liquidity needs without adversely affecting its operations or condition.
2) The availability of assets readily convertible to cash without undue loss.
3) Access to money markets and other sources of funding.
4) The level of diversification of funding sources, both on- and off-balance sheet.
5) The degree of reliance on short-term, volatile sources of funds, including borrowings and time deposits, to fund longer term assets.
6) The trend and stability of deposits.
7) The capability of management to properly identify, measure, monitor, and control or mitigate the bank’s liquidity position, including the effectiveness of funds management strategies, liquidity policies, MIS, and contingency funding plans.

Liquidity Ratings:

Rating 1: indicates strong liquidity levels and well-developed funds management practices. The bank has reliable access to sufficient sources of funds on favourable terms to meet present and anticipated liquidity needs.

Rating 2: indicates satisfactory liquidity levels and funds management practices. The bank has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

Rating 3: indicates liquidity levels or funds management practices in need of improvement. Banks rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

Rating 4: indicates deficient liquidity levels or inadequate funds management practices. Banks rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

Rating 5: indicates liquidity levels or funds management practices so critically deficient that the continued viability of the bank is threatened. Banks
Risk-based bank supervision manual

2.6. Sensitivity to Market Risk

The Sensitivity to Market Risk component reflects the degree to which changes in interest rates and foreign exchange rates, commodity prices, or equity prices can adversely affect a bank’s earnings or economic capital. When evaluating this component, consideration should be given to:

1) Management’s ability to identify, measure, monitor, and control or mitigate market risk;
2) The institution’s size;
3) The nature and complexity of the bank’s activities; and
4) The adequacy of its capital and earnings in relation to its level of market risk exposure.

Two most common components of sensitivity to market risk are interest and foreign exchange rates, for which evaluation factors include, but are not limited to, the following:

1) The sensitivity of the institution's earnings or the economic value of its capital to adverse changes in interest and foreign exchanges rates;
2) The ability of management to identify, measure, monitor, and control or mitigate exposure to market risk given the institution’s size, complexity, and risk profile;
3) The nature and complexity of market risk exposure arising from non-trading positions.
4) The nature and complexity of market risk exposure arising from trading positions.

Market risk Sensitivity Ratings:

**Rating 1:** indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the bank. The level of earnings and capital provide substantial support for the degree of market risk taken by the bank.

**Rating 2:** indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or
capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and the level risk accepted by the bank. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

**Rating 3:** indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level risk accepted by the bank. The level of earnings and capital may not adequately support the degree of market risk taken by the bank.

**Rating 4:** indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level risk accepted by the bank. The level of earnings and capital provide inadequate support for the degree of market risk taken by the bank.

**Rating 5:** indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the bank is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level risk accepted by the bank.

### 3.5. Step 6 – ON-GOING OFF-SITE SUPERVISION

#### 3.5.1. Objectives

- To keep abreast of events and changes in the risk profile of the bank.
- To ensure timely application of corrective actions and to ensure that those actions are achieving desired results.

#### 3.5.2. Background

The purpose of off-site supervision is two-pronged: the on-going analysis of periodic bank financial data and follow-up reviews to ensure corrective actions are taken in a timely manner and that such actions are achieving the desired results.

The CBK evaluates risks on an on-going basis through monthly off-site analysis of financial data submitted by each bank. This allows the CBK the opportunity to monitor and evaluate an individual bank’s and the industry’s current position and performance over different periods of time. This brings closure to the Supervisory Cycle as it returns to Steps 1 and 2 of the Risk Based Supervision Process.
Supervisors should be able to monitor the financial condition of the bank on an on-going basis. Since it is not possible to be continually on-site, a system of off-site surveillance, often called monitoring, has become a widely accepted method within bank supervision.

The external examiners review the periodic reports presented to the supervisory authority. These reports are analyzed for prudential supervision purposes by reviewing financial data, primarily through key ratios. Trained analysts use such data to identify potential problem areas at an early stage. In a comprehensive system of bank supervision, problems or weaknesses discovered through off-site supervision should lead to more thorough investigations through on-site examinations.

Off-site surveillance has several advantages, such as:

- Monitoring banks on a regular basis, at least on a quarterly basis, or monthly, and even weekly in some key areas such as liquidity.
- Comparing banks to each other using a standard database, and such data is easily computerized.
- Requiring fewer staff for off-site surveillance and complementing the work of labour intensive on-site examinations.
- Detecting adverse changes between on-site examinations quickly.
- Allocating valuable resources in examination planning by identifying areas of concern and selecting the timing and appropriate scope of the examination.

It is equally important to understand the disadvantages that often exist in off-site surveillance:

- If appropriate accounting standards are not defined and implemented, the data can often be misleading and inaccurate.
- Data submitted can be inaccurate or incomplete, especially for banks with large branch networks. The data used often are not drafted for the purpose of prudence, especially if the main purpose of financial reporting is for the monetary policy or for statistical purposes.
- Data does not always disclose problem areas and will not provide the reasons for such problems.

Computerization gives the CBK prudential ratios from the various reports submitted to the bank. Such ratios are used as indicators on capital, asset quality, earnings, and liquidity. Using this computerized data and ratios for all banks, the analysts use two basic methods for off-site analysis:

- Trend analysis: where the analyst looks to see if various key ratios show an improving or deteriorating trend over time. An example of this would be the ratio of past due or non-performing loans to total loans; if the ratio is on the increase, this may be a sign that asset quality is weakening.
- Peer group analysis: where the bank being reviewed is compared to other bank’s with similar characteristics using various key ratios. Peer group analysis will
show, for example, if a bank’s capital ratio is higher in comparison to other banks of similar size or if a bank with low or declining ratios compared to its peers may need closer supervisory attention.

Using the trend and peer group analysis from computerized data the off-site analyst detects weak areas or emerging problems in bank which should result in further review, usually by performing an on-site examination or conversations with bank management.

It is important to understand that off-site analysis is only one step in the supervision process. It must be fully integrated into the whole process, especially with on-site examinations, to be truly effective. Off-site surveillance can help provide some early warnings for potential problem areas in banks, but it cannot, in itself, be a complete system for the effective supervision of banks.

*Monitoring of Corrective Action Measures - once a bank has been advised of the areas where corrective action is warranted and expected, the CBK conducts periodic follow-up reviews to ensure timely application of corrective measures.*

The objective of these follow-up reviews is to evaluate implementation of the supervisory directives and recommendations made to the institution. The EIC maintains an on-going list of issues raised during an on-site examination as well as off-site analyses to be discussed with the institution’s management within a specified timeframe. Not only are these results communicated to the bank, they are also incorporated into Institutional Overview updates.

3.5.3. Procedures

**On-Going Off-Site Analysis:**

I. Obtain financial reports from the banks:
   
   A. Maintain record of date data received;

   B. Contact bank if report is not received by the 15th of each month;

   C. If data is not received as required, contact the bank and request an explanation for the report being late and obtain a submission date from the bank;

   D. If a bank is repeatedly late in the submission of its reports, make a recommendation to BSD management to initiate corrective actions;

II. Review data submitted for material errors, such as incomplete schedules or errors which are inconsistent with CBK report instructions.

   A. Ensure numbers and schedules tie together.
B. Identify errors that are made consistently by many of the banks. In this case, CBK reporting instructions may need to be revised or clarified.

III. Prepare to complete and/or update the bank’s Institutional Overview.

A. Review the most recent written ROE and CAMELS ratings for individual banks.

B. Review any document related to any Enforcement Action between the CBK and the bank.

C. Review the bank’s correspondence file for all letters between the CBK and the bank, clippings from periodicals and newspapers that relate to the activities of the bank and its personnel, adverse publicity, adverse economic events in the community and in the home country of a bank’s foreign owner, natural disasters, banker death or disappearance, large financial commitment as sponsor or lead financial institution in a major project or development, etc.

D. Review any licensing applications, either previously approved or pending, such as a merger, acquisition, or establishment of a new branch or subsidiary.

E. Review bank related data such as a change in external auditors, large defalcation, large pay down or payoff of previously classified loans.

IV. Complete and/or update the bank’s Institutional Overview.

A. Overall Condition: Summarize comments on the bank’s overall condition based on the level of concern, assessment of risk management systems and adequacy of management oversight. Any key issues/concerns relating to the strategies employed should also be highlighted.

B. Corporate Overview:

1. Background: Capture the history of the bank in brief covering, among other things, date of establishment, name changes (if any), mergers and acquisitions, conversions of bank license, etc.

2. Shareholding Structure: Indicate names of shareholders owning 10% or more of the outstanding shares, number of shares held and percentage shareholding over the past three years. If the bank is owned by a holding or parent company, this is also shown for the holding company or parent’s shareholding structure – to the extent known. (Review annual reports of the holding company or parent company to obtain this information).

3. Capital Structure: List the bank’s capital components over the past three years in tabular form.

4. Related Organizations: Present in tabular form, the bank’s subsidiaries, affiliates, and any other related organization showing the percentage owned by the bank of each – or how the organization is related.

5. Vision, Mission, and Strategy: State the bank’s vision, mission, values, and strategic goals and initiatives. Comment on the bank’s strategic initiatives, forecasts, projections for key performance areas, budget projections, and/or new markets and products.
6. Key Functional Lines: Identify the bank’s key functional lines and products offered each line. Also include the major support services such as Information and Communications Technology (ICT).

7. Risk Management Framework: Provide details of the risk management structures, systems, and procedures used to manage the various risks inherent in the bank’s operations. The roles and responsibilities of individuals and departments involved in the risk management process should be clearly articulated. BOD and senior management reports, limits in place and IT Systems capabilities should be addressed.

8. Branch Network: Indicate the number of branches, agencies, and other points of representation and their respective physical addresses.

9. Staff Compliment: State the total number of employees, indicating managerial and non-managerial staff for the bank. Where necessary, comment on the adequacy of the human capital particularly in key operational areas, in respect of numbers, qualifications, and skills.

10. External Auditors: Show the names, addresses, telephone numbers and the auditor and attorney in charge and indicate the number of years these auditors and attorneys have provided service to the bank. In addition, take note of other consultancy assignments they may have undertaken for the bank.

11. BOD: Present in tabular form, the names, ages, occupations, qualifications, experience, and other directorships of all the members of the BOD and companies in which they hold shares. Further, BOD members must disclose explicitly any other business relationships that they or their spouses have with the bank.

12. Senior Management: Present in tabular form, the names, ages, qualifications, and experience of all senior managers and companies in which they hold shares. Further, senior management must disclose explicitly any other business relationships they or their spouses have with the bank.

13. BOD Committees: State the compositions of the various BOD committees and their terms of reference. Comment on any irregularities.


15. Overview of management: Comment on the adequacy of BOD and management oversight in terms of:

   a. The overall risk management framework;
   b. Policies and procedures in key risk areas;
   c. Internal control systems;
   d. Strategic planning and policy formation.

   Also comment on the MIS in terms of reliability and timely production of financial and/or regulatory reports.
16. Twenty Largest Borrowers: Present in tabular form, the twenty largest borrowers showing the counterparty, limit, current balance, and maturity date, nature of exposure, and security type. Further, show the amount outstanding for each borrower as a percentage of regulatory capital.

17. Twenty Largest Depositors: Present in tabular form, the twenty largest depositors showing name of client, amount and type of deposit. In addition, capture the cost of borrowing.

18. Industry Rankings: Present in tabular form, the bank’s position in relation to other banks in the same sub-sector. Show total deposits, total loans, total assets and total capital by amount, percentage, and market share.

C. Examination Results, Audit Findings and External Credit Rating.

1. Results of Past On-Site Examinations: Present in tabular form, the results of the last three on-site examinations showing the respective overall and CAMELS ratings as well as risk ratings.

2. Significant Findings of Last On-Site Examination: Summarize the significant findings of the last on-site examination.

3. External and Internal Audit Findings: Summarize the significant findings of the most recent external and internal audits, and highlights of prudential meetings with the auditors.

4. External Credit Rating: Indicate the latest ratings obtained by the bank for itself or parent or holding company. Give the rating, the date it was assigned, and the name of the rating company or agency.

D. Off-Site Analysis as of (latest date):

Provide a summary of the overall conclusions of the bank based on the most recent financial returns, and comment on the following (see Appendix X for summary of key ratios):

1. D1 – Capital Adequacy
2. D2 – Asset Quality
3. D3 – Management
4. D4 – Earnings
5. D5 – Liquidity and Funds Management
6. D6 – Sensitivity to Market Risk

E. Violations of Law and Non-Compliance with Regulatory and Supervisory Requirements:

Comment about the compliance of the bank with the applicable legislation. Mention every violation identified and action that was or will be undertaken.

F. Environment Considerations:
Identify and comment on any external environmental factors which may have an adverse impact on the operations and condition of the bank; for example, property, debt and equity markets, and other significant economic conditions.

G. Financial Stability and Stress Testing Assessment:

1. Financial Stability Considerations: Comment on the bank’s financial performance, brand strength, weaknesses, and the contagion effect on the financial system, in the event of default.

2. State the assumptions and results of stress tests conducted by the BSD, other departments within BCK and the bank itself.

V. Complete and/or update the Risk Matrix by:

A. Determining the quantity or level of inherent risk in each functional area or activity;
B. Assessing the adequacy of risk management systems to manage risks for each functional area;
C. Determining the functional composite risk profile for each functional area;
D. Determining the aggregate inherent risk rating profile for each inherent risk across the bank;
E. Assessing the adequacy of aggregate risk management systems for each inherent risk across the bank (per risk management system and aggregate basis);
F. Assessing the overall composite risk for each inherent risk across the bank;
G. Determining direction of overall composite risk per inherent risk across the bank;
H. Determining the entire bank’s overall inherent risk, overall risk management systems, overall composite risk, and direction of overall composite risk.

VI. Complete the written Risk Assessment which should incorporate the following:

A. An overall risk assessment of the bank;
B. The types of inherent risks, their level and direction;
C. The identification of all major functions, business lines, and products from which significant risks emanate;
D. A description of the bank’s risk management system;
E. The relationship between the likelihood of an adverse event and its potential impact on the bank; and,
F. A comment on the consolidated risk management system and the internal and external audit functions.
VII. Monitoring of Corrective Action Measures:

A. Obtain and review recent correspondence and other reports submitted by the bank.
B. Compare steps taken to those required by CBK.
C. Perform analysis of areas of concern to ascertain the level of improvement, if any.
D. Based on results from step III, determine supervisory action to follow and update the Supervisory Plan, if necessary, to reflect one of the following: continue to follow supervisory plan; increase reporting timeframes; schedule targeted examination; amend corrective action. If appropriate, present the revised Supervisory Plan to department management for approval.

3.5.4. Appendix X: Summary of Key Ratios

1. Non-performing Loans/Average Loans or Gross loans: if > 10 percent, then asset quality should be closely monitored.
2. Non-performing Loans/Total Capital: if >35 percent asset quality and capital should be closely monitored. If >100 percent, then bank should be considered a problem institution.
3. Allowance for loan and lease losses/Gross Loans: if < one percent bank should be encouraged to increase ALLL on a regular basis.
4. Non-performing loans/ALLL: if ALLL is insufficient to cover non-performing loans, then ALLL is grossly inadequate.
5. Net Losses to Average Total Loans: if ratio is high when either compared to peer or when compared to the bank’s historical data, then inquire as to why is it this way.
6. Temporary Investments/Total assets: Should be sufficient to be utilized as a secondary source of liquidity if needed (standard is at least 10 percent).

7. Temporary Investments/Volatile Liabilities: reflects how much volatile liabilities are funded by short-term assets. If < 100 percent make sure management has a plan or way to payout the volatile liabilities if the need arises.
8. Net Loans/Core Deposits: if > 100 percent make sure management realizes that any further increase in loans will be funded by volatile liabilities. Thus, any new loans would have to be of the highest quality and short term. Make sure that the bank is not funding long-term loans with short term volatile liabilities.
9. Volatile Liability Dependence: if positive it means volatile liabilities, which could leave the bank quickly, are funding longer term assets. Determine how long management intends to remain in this position and assess overall risk to the bank.
10. Net Loans/Total deposits: if ratio is > 70 percent loan growth should be closely monitored and bank management should be encouraged to curtail any further increase in the loan portfolio.
11. Return on Average Assets (ROAA): Historical trend of bank is important, and comparison to peers should be analyzed. Note any significant deviations.
12. Net Interest Margin (NIM): Trend is very important and comparison to peers. Note any divergences.
13. Net Non Interest Expense to Average Assets: Trend is very important and comparison to peers. Note any divergences.
14. **Average Assets/Number of Full time employees**: Trend is very important and comparison to peers. Note any divergences.

15. **Average Personnel Expense/Number of Full time employees**: Trend is very important and comparison to peers. Note any divergences.

16. **Tier 1 Capital/Risk-weighted assets**: If below CBK guidelines bank should be requested to develop a written capital plan immediately.

17. **Total Capital/Risk-weighted assets**: If below CBK guidelines bank should be requested to develop a written capital plan immediately.

18. **Total Capital/Average Assets**: If ratio’s trend is declining should seek to know why from bank management because capital should grow along with assets.

19. **Cash Dividends/Net Income**: If > 30 percent, capital growth should be monitored to ensure that it grows as fast as assets, total deposits, etc.

20. **Return on Equity (ROE)**: A bank should strive to always get this ratio equal to or > 15 percent. Anything < 10 percent should get bank management to seek ways to improve earnings.
4. EXAMINATION OF BRANCHES OF FOREIGN BANKS

During the examination of the branches of foreign banks, the same assessment procedures of the minimum and standard scope will be used, as during the examination of banks.

During the assessment of foreign banks branches will be used the assessment system “AIM”, which consists of the following components:

1. Quality of assets;
2. Internal controls and audits; and
3. Management.

During the assessment of components it will be used: 1, 2, 3, 4 and 5 as specified in assessing the banks and will be based according to the Guidelines for Assessment by CAMELS System.

5. ENTRY INTO FORCE

This manual enters into force upon its approval.

Bedri Hamza

Chairman of the Executive Board
Efficiency of Banks in South-East Europe: With Special Reference to Kosovo

CBK Working Paper no. 4