Advisory Letter 2006-2 **11 May 2006**

Unsafe and Unsound Practices by Banks

During the course of examinations, BPK has noted certain practices that are considered to be unsafe and unsound. These are provided to you for your awareness. We suggest that General Managers review practices in their banks to ensure that these do not occur/recur. From time to time, BPK will update this list as practices are disclosed during supervisory activities. These practices will be criticized in reports of examination and may be the basis for further supervisory actions by BPK.

Inadequate audit/control of cash. BPK has determined that some branch managers were running private loan books out of cash at their branches while falsely reporting total cash on hand to the main office.

Reciprocal" deposits with correspondent banks. BPK noted that some banks were placing funds on deposit at their correspondent bank with the correspondent then placing the deposit or a portion thereof back with the Kosovar bank. This served to overstate deposits and falsely improve loan to deposit ratios. It also served to overstate liquid assets in the sense that the correspondent balance was not actually available to satisfy general liabilities. Further, these transactions were at a rate differential that was adverse to the Kosovar bank.

Reporting blocked correspondent balances as liquid assets. Banks were found to be reporting as free balances the entire amount of their correspondent bank accounts when in fact a large portion of the balance with a correspondent may have been blocked to secure guarantees or other credit transactions. This served to overstate the true amount of liquid assets available to satisfy general liabilities.

Transferring funds for clients without an offsetting accounting entry. Instances were identified where a bank would transfer funds on behalf of a client, but would not charge the client's account if there was insufficient funds. Instead, no offsetting accounting entry would be made, or the deficit would be carried in a suspense account. These transactions understated lending by the bank.

Payment of old loans with new/restructured loans without any change in credit factors to support the new loan/restructuring. Usually the new advances were made to avoid or correct delinquency and remove the exposures from classification and provisioning requirements. These transactions resulted in false reporting of asset quality, provisioning needs and earnings.

Recognition of interest income on restructured delinquent loans. The above-mentioned restructurings or new loans often capitalized delinquent interest into the new principle amount. These transactions overstated interest income and ultimately capital.

Reversal of provisions on the basis of restructuring without any change in credit factors to warrant the reversal. These transactions tended to overstate income through provision recapture.

Granting of working capital advances/lines with maturities of 18 months to 3 years. BPK considers such advances not to be working capital lines. Most lines were fully drawn at origination and remained at the fully drawn amount up to the maturity date of the line. No supporting documentation evidenced the specific working capital need or any analysis of turnover in working assets upon which interim payment of advances under the line might be expected or required. BPK considers such lines as term credits and should be structured accordingly. This reflects poor credit administration.

Sometimes, borrowers were given two and three working capital lines simultaneously, or substantial and frequent overlines were permitted. Often, no formal analysis or approval was seen for the overlines. This reflects poor credit administration, inadequate analysis of client needs and a lack of control over the credit.

Inadequate/nonexistent analysis of borrower cash flows that necessitated frequent rescheduling. This too reflects poor credit administration and a lack of understanding of the clients' businesses.

Inadequate documentation of use of loan proceeds. Invoices, both pre- and post-advance were not required, were inconsistent with the borrower's business or were false. Loan disbursements often were made directly to the client's deposit account with subsequent withdrawal in cash by the client; no transfer of proceeds was made to the client's vendor. The transactions cause the bank to have no control over the use of the loan or to validate the proper use of proceeds. There is no audit trail. These transactions also open the possibility of the bank's exposure to money laundering

Lack of adequate financial information on which to base the credit. Banks consistently failed to obtain meaningful/reliable financial information on the borrower or to verify the content of financial statement information. BPK observes that most financial information is of poor quality and not analyzed. In some instances, the authenticity of the financial statements appeared questionable.

Lending against collateral rather than against borrower's ability to repay. Such a practice increases the credit risk markedly. This is even more aggravated by the fact that several banks failed to verify the existence, condition and value of the collateral and/or failed to record a pledge agreement.

Weak internal loan review and classification processes. BPK observed that several banks classify exposures strictly on the basis of delinquency status, rather than an assessment of the overall condition of the credit and the borrower. Such methodology is clearly insufficient for early and accurate identification of prospective credit problems and provisioning needs. .

Lending to insiders on preferential terms. Often, preference took the form of extended grace periods, lower rates, extended maturities or failure to enforce repayment requirements. Some credits would not have been granted to "arms-length" borrowers of equal credit worthiness.

Lending to nominees to circumvent the legal limits (often for insiders). This practice has been found to be prevalent. Companies were created solely for the purpose of receiving loan funds, which ultimately were transferred to another party (often a director or shareholder or their related business). In some instances, legitimate unrelated businesses borrowed, but then transferred a portion of the funds to an insider. In the latter case, BPK often found no economic relationship between the parties that would support the transfer.

Failure to adhere to supervisory orders/agreements. In fact, purposeful disregard or circumvention of the requirements imposed by BPK was found during follow-up visits or through off-site monitoring.