PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE

PFTAC

HANDBOOK FOR PACIFIC BANK AND PENSION FUND SUPERVISORS: OFF-SITE & ON-SITE WORK

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PREFACE

This is the second of the *PFTAC HANDBOOK SERIES* publications. The purpose of this new series of handbooks is to build capacity in the public sector for Pacific Island States. Although there are some theoretical approaches included in the handbooks, the main intention is to provide *practical, hands-on, contextual* advice for counties at various stages of developing fiscal, monetary and statistical systems.

While the 15 Pacific Island members of PFTAC all share certain similarities, including small size, large distance from each other and the rest of the world, limited resources and capacity, and reliance to varying degrees on donor aid and/or large remittance inflows, the countries have quite different situations in political and economic governance and institutions. Each country faces different challenges to financial sector supervision, and we hope the following pages provide pragmatic guidance the various situations.

Under the general guidance and support of the International Monetary Fund (IMF), the Pacific Financial Technical Assistance Centre (PFTAC) is fortunate to enjoy financial support from the Asian Development Bank (ADB) and the Governments of Australia, Japan, Korea and New Zealand. We gratefully acknowledge as well the Association of Financial Supervisors of the Pacific Countries (AFSPC), for which PFTAC serves as general secretariat, and from which many of the cases presented in this handbook originate.

Most importantly, the PFTAC team has been privileged to work effectively over a number of years with Pacific Island States to achieve measurable improvements in economic management. The experience we have developed through our numerous in-country interactions provide the richest source of lessons for the writing of this handbook. We stand ready as a partner to carry that work and experience forward in the future, and hope that this handbook contributes effectively to that partnership.

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INTRODUCTION

The role of a supervisor is founded on the need to maintain the safety and soundness of the financial system; confidence in the financial system is, in turn, a pre-requisite for economic growth. A primary motivation for financial sector supervision is to protect the interests of depositors, policy holders in the case of insurance companies and beneficiaries in the case of pension funds.

An effective supervisory framework for banks, insurers and pension funds depends on a number of factors, with the key elements being a sound legislative basis which enables supervisory agencies to collect a range of data on the performance of supervised entities, the ability to meet with the Board and management on a regular basis, and the power to conduct on-site inspections to ensure that the supervised entities have prudent risk management policies in place (e.g., in the areas of credit risk and investment policies). Supervisory legislation also needs to give supervisors power to act against entities, including the ability to issue directives and regulations, the power to take control of an entity experiencing difficulties and, in the extreme, to close and wind-up an entity which is insolvent or conducting its operations in a manner detrimental to the interests of stakeholders.

The purpose of this manual is to assist Pacific Island supervisory agencies to carry out their supervisory duties covering banks and pension funds, and to provide some practical advice. With this lofty ideal in mind, the aim and purpose of this manual is twofold:

- Firstly, to provide on-going assistance to supervisors; and
- Secondly, to provide a reference manual that can be used as a training guide for new supervisory staff.

The topic of insurance supervision, which to some extent is more complex as it covers life and non-life insurance, is to be the subject of a future handbook in this PFTAC series.

The approach adopted in developing this manual is that the *prime responsibility for the prudent management of a bank's or pension fund's business lies with the institution itself*. Therefore the manual is directed towards the supervisory agency's being able to satisfy itself that individual institutions are following management practices which limit risks to prudent levels and that the supervisory agency's legislative requirements and prudential guidelines are being observed by supervised institutions. Of course, supervisory agencies should review their supervisory framework to take account of changing circumstances.

Through the analysis of statistical data and other information received, and the undertaking of regular on-site examinations and meetings with the management of supervised institutions, supervisors should be in a position to:

1. Summarize all prudential data, analyze trends and identify changes to strategy or changes in an institution's approach to risk management; and
2. Identify potential weaknesses and recommend possible solutions or courses of action which can be discussed with an institution's management.

The combination of off-site analysis and on-site work should enable the supervisor to form a view of the institution. **Off-site** work forms the basis of the supervisory work and will aid in focusing the scope of **on-site** inspection. Off-site work should complement on-site work and enable supervisors to encourage and promote sound prudential management practices, and through the on-site inspection program evaluate the effectiveness of those practices.

The manual has been structured to provide a step-by-step guide to both off-site and on-site supervision. In relation to off-site supervision, the analysis of all statistical returns and other material and information is covered at a general level as supervisory agencies in the Pacific have different types of prudential reports which, at the end of the day, cover the same standard data. Planning for prudential consultations and a proposed structure for briefing notes is also included. In the area of on-site supervision, issues relating to pre-planning and conducting a visit are also addressed. In all areas, key concepts and issues are explained. The manual also provides thoughts for the writing of notes and analysis.

It is important to note that this manual is a guide only and in some cases, the work practices of supervisory agencies may go beyond what is outlined in this manual. In addition, this manual cannot hope to cover every possibility, so it is therefore important that supervisors continue to keep themselves abreast of new developments and issues that will affect the financial institutions and the financial system. Supervision continues to evolve so, to some extent, this manual should be considered as the foundation on which a good supervisory process can be built and further developed.

In writing this manual, I have drawn on my experiences in the provision of technical assistance to supervisors throughout the Pacific, my time working with the Reserve Bank of Vanuatu and of course my years working in the Reserve Bank of Australia and the Australian Prudential Regulation Authority.

Finally, I would like to thank the International Monetary Fund for giving me the opportunity to work in the Pacific for the past six years. My family and I have made a number of good friends throughout the region and we look forward to continuing these friendships. Of course, the views expressed in this manual are mine and should not be attributed in any way to either the Pacific Financial Technical Assistance Centre or the International Monetary Fund.

Andrew Milford — Suva, Fiji
PFTAC Financial Sector Supervision Advisor — October 2007

CHAPTER 1 – THE ROLE OF THE SUPERVISOR

1. Overview

The role of the supervisor is not easily defined. A good supervisor could probably be best described as a "jack of all trades and master of none." Supervisory staff must understand prudential guidelines, the legislative framework and issues confronting institutions. It is important that supervisors **ask questions**. Issues that one supervisor may be trying to understand may have previously been considered by another supervisor either in the same office or elsewhere in the Pacific. Supervisors should establish good working relationships with other supervisors, for example other member countries within the Association of Financial Supervisors of Pacific Countries (AFSPC). Relationships can also be established through attendance at training courses.

Supervisors should also research issues. For example, if a bank is planning to introduce a new product into the market that is not understood, supervisory staff should conduct research on the Internet. Having done this, the supervisor should meet with the bank and discuss the proposal. Questions should be asked if, having researched the issue, aspects of the product/proposal are unclear and, to assist the supervisor to better understand how the product/proposal fits the bank's strategy and how the risks will be managed and controlled.

Being a good supervisor is to a large extent about developing good relationships with the supervised entities and understanding what they are doing. As supervisors, you should be willing to ask questions. You might find that some of the issues you raise may not have been considered by the entity. As supervisors you are also in a unique position; you have the benefit of seeing what other market participants are doing and therefore you can identify 'best practice' and recommend improvements to those institutions whose risk management practices are weak.

Supervisors are also expected to exercise their judgment in either approving a transaction or providing advice to senior management on supervisory matters. In considering an issue you should take into account: the nature of matter, and legislative and prudential concerns. Often you will find that there may be no right answer and then you as the supervisor need to ensure that you fully understand the nature of the proposal and the ramifications of your decision or recommendation.

2. An effective supervisory framework

A primary motivation for financial sector supervision is to protect the interests of depositors, policy holders in the case of insurance companies and beneficiaries in the case of pension funds. An effective supervisory framework covering banks, insurers and pension funds depends on a number of factors, with the key elements being a sound legislative basis which enables supervisory agencies to collect a range of data on the performance of supervised entities, the ability to meet with the Board and management on a regular basis and the power to conduct on-site inspections to ensure that the supervised entities have prudent risk management policies in place (e.g., in the areas of credit risk and investment policies). Supervisory legislation also needs to give supervisors power to act against entities and this includes the ability to issue directives and regulations, the power to take control of an entity experiencing difficulties and, in the extreme, to close and wind-up an entity which is insolvent or conducting its operations in a manner detrimental to the interests of stakeholders.

The Basel Core Principles (BCPs) define 25 core principles that are needed for a supervisory system to be effective. As a matter of good practice supervisors should be familiar with the BCPs and from time-to-time conduct self assessments against the BCPs. Those principles are broadly categorized into seven groups: Objectives, independence, powers, transparency and cooperation (principle 1); Licensing and structure (principles 2 to 5); Prudential regulation and requirements (principles 6 to 18); Methods of ongoing banking supervision (principles 19 to 21); Accounting and disclosure (principle 22); Corrective and remedial powers of supervisors (principle 23); Consolidated and cross-border banking supervision (principles 24 and 25).

The objectives of the *Principles of Private Pension Fund Supervision* are to promote the stability, security and good governance of pension funds and plans, and to protect the interests of pension fund members and beneficiaries.

Perhaps one of the key requirements is set out in BCP 20 – Supervisory techniques*:* This requires that an effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management. In a similar vein, the effective supervision of pension funds also requires both on-site and off-site supervision.

Figure 1: The relationship between off-site monitoring and on-site examinations

It may be useful for supervisors to map their legislative provisions and requirements to the Basel Core Principles. Attachment 1 provides a sample template.

3. Written Work & Analysis

One of the main requirements of being a good bank supervisor is being able to write in a clear and concise manner. **Analysis should be presented in a concise manner**. It should not be a "race-call" of movements. Rather, it should try and add "substance" and explain why things moved---tie movements to changes in strategy and market conditions. When analyzing a movement, ask yourself: is this consistent with what I know about the institution or developments in the market? **Written work should also be completed in a timely fashion for two main reasons.** Firstly you will be able to recall aspects of discussions and secondly the issues/concerns will still be relevant, thereby giving senior management time to make an informed decision before it is too late.

Many of the notes that you will write will be considered by senior bank staff who may not have the same in-depth understanding of issues. Reports of observations from on-site inspections and prudential consultations will be provided to institutions. It is therefore important that written work, and especially letters, be professional and mistake free. If a letter or report contains factual errors or is expressed poorly it is unlikely that the reader will take you or your supervisory agency seriously.

3.1 Reports - Content

A significant percentage of the supervisor's job involves writing reports. The following list outlines some of the types of reports and the circumstances in which they are written. The content of some of these reports will be expanded upon in other sections of the handbook.

Type of report	Typical content
Background note	Prepared in response to request from Governor/Commissioner/Senior management to provide brief information on an institution or other issue. The note should be brief, highlighting key issues and areas that may be covered in the meeting.
Diary notes	Diary notes are minutes of conversations with institutions and others. Minutes of meetings and discussions with institutions need to be carefully documented. While they need not record who said what, they should: – distill the key issues and messages delivered – be written in a way to bring together related topics; therefore supervisors should **use headings, as conversations tend to flow**. Diary notes form an important part of being a supervisor. Such notes could form the basis of enforcement or other action against an institution. These minutes also form part of the on-going supervision of an institution. For example, minutes from prudential consultations will include a range of information on a bank's performance, strategy etc., and can form the basis for on-site inspections. The minutes also form part of the supervisor's records and can be used by other staff members who may supervise the institution in the future.

Quarterly report	Analysis of statistical or other information. Use graphs or tables to highlight movements/trends in data but **not** both as it is repetitive. Decide whether a table or graph best gets the message across.
Prudential consultation background note	The prudential consultation background note brings together all information – prudential and other – on an institution's operations over the past 12 months. As a guide, the note should be presented in the following format, with appropriate attachments: • Overview/Executive Summary – highlighting issues that need to be raised with bank management. • Strategy • Balance sheet • Performance • Asset Quality & Risk Management • Capital Adequacy • Large Exposures • Country Exposures • Maturity Profile & Liquidity • Other (e.g., on-site visits)
Background note for on-site inspection	Such a note should be prepared prior to the commencement of an on-site inspection to highlight issues relevant to the on-site work (e.g., lending concentrations, credit standards, provisioning policies, AML/CFT concerns). The briefing note should provide a summary of the institution and cover: • Major activities; • Balance sheet developments; • Issues identified from off-site analysis such as asset quality; • Risk management issues, i.e. changes to systems; • Concerns arising from previous inspections; and • Overview of risk management system (credit or AML as appropriate).
Examination report	Examination reports are important in the

	supervisory process. Such reports: • Form the basis of formal discussions with bank management. • Provide the basis for supervisory action plans. • Provide focus for future visits to ensure that supervisory resources are devoted to areas/issues of concern. Diary notes/minutes should be prepared on each meeting. The notes should outline main issues discussed, messages delivered and actions agreed. An assessment or summary note of the visit should be prepared. This note brings together major issues and concerns identified during the visit. This note is important as it forms the basis of formal correspondence with bank management.
Other ad-hoc reports	Such reports include reviews of annual reports, newspaper articles etc., which typically cover a review of annual profit results, strategic developments and new services & products offered by the institution.
Policy development	Consideration of a proposal/market development/new supervisory statement. This may require discussions with institutions and other stakeholders and an assessment of the impact on institutions and the supervisory agency.
Industry report	For example, such a report may cover industry wide trends in the banking sector (e.g., asset quality, balance sheet etc) and can be used to form the basis of BSD's board reports.

3.2 Report writing – some tips

The main aim of off-site work is to analyze data collected from institutions to enable the supervisor and senior management to form a view about the soundness or otherwise of the institution. When undertaking analysis, it is important that the analyst considers the data in context, i.e. against the institution's strategy, market conditions and any other factors relevant to the institution (e.g., a change in the parent bank's strategy).

The key to writing a good examination or off-site report is to be able to distill the key issues for management's attention. It is not necessary that the report include details of every movement/discussion with the bank for management. (This does not mean that a supervisor should not understand/query movements). **An analyst should be in a position to answer any questions from management about a bank for which he has supervisory responsibility.**

Some general comments include:

- If discussing movements using percentages, make sure that you have included an amount, e.g., 'assets fell by 10%' means nothing unless referenced to an amount. If nothing happened (i.e. no significant movements/changes over the quarter) then say so. There is no point trying to write a long report about nothing.
- Use 'headings' for clarity. This will assist structuring the note.
- Pre-visit background notes should contain the latest data (so contact the institution to see if they can provide information early).
- Complete examination reports straight after the visit while the issues are still fresh and you can remember what your notes of conversations mean.
- Ask your colleagues to review reports to make sure they are accurate. (Remember that the notes of these inspections and consultations will form the basis of a final report and a careless or inaccurate post-visit report could place the supervisor's reputation in question or just raise concerns about how much they really did understand).
- Discuss issues and concepts with your colleagues.

3.3 Trend and Ratio Analysis

When writing reports based on an analysis of off-site data, consideration needs to be given to trends in data or ratios. The best way to present such analysis would be with graphs showing, say, 5 quarters of data for capital and 12 months for balance sheet data. As the following examples indicate, considering trends in data will lead to other questions/issues that may need to be discussed with a bank's management.

- If a bank's capital ratio has been declining because of increased growth, you should discuss the issue with bank management before the situation becomes critical – as supervisors we expect that banks will have in place internal trigger ratios and similarly we should as well. Accordingly, it would be appropriate to hold discussions with a bank and ask for details of its capital management plan.

- Trends in impaired assets – are they showing continued increase and if so, what is driving the increase (e.g., home lending, business lending)? If impaired assets are increasing what is happening to the level of provisions? You may need to discuss asset quality and provisioning with bank management. The decline in asset quality may also mean that an on-site inspection should be conducted to review the bank's approach to credit risk management and to enable the supervisor to better understand the bank's approach strategy for dealing with its problem assets.

- Trends in the balance sheet – what is driving the growth/decline and is this consistent with the bank's strategy?

Ratios are an important tool; however, it is important to understand the components of the ratio as the ratio can be influenced by either the numerator or the denominator and without fully appreciating the underlying numbers, a supervisor could be misled into believing that a bank is in a sound financial state when that might not be the case. For example, a supervisor should be aware that a high Return on Equity (ROE) does not necessarily indicate satisfactory performance from the point of view of the supervisor. The adequacy of the capital needs to be taken into account. A modest return on assets, for example, when related to inadequate capital may well result in a high return on equity. While that may be good for the shareholders, it needs to be put in a different context from the regulatory and supervisory perspective.

3.4 Peer group analysis

Peer group analysis is useful; however, given the size of most banking systems in the Pacific, it is probably of limited value. The aim of peer group analysis is to establish groups of banks which undertake similar activities, e.g., mainly retail banks involved in the local market with a focus on small scale domestic lending, mainly wholesale banks involved more in the corporate lending or that undertake a significant level of business in international markets.

Peer group review is important as it enables a bank supervisor to see if a bank is an outlier, i.e., do data on a bank suggest that it is moving in a different direction to its peers or is it exceeding peer group growth/averages?

Such analysis enables a bank supervisor to focus both on-site and off-site analysis. It must be noted that the management of an outlier bank may have valid reasons for how the bank compares with its peers. However, it is up to the supervisor to understand why and perhaps give consideration to developing a plan to deal with the situation, e.g., raise concerns with the Board, increase frequency of inspections, etc.

4. Understand the Relevant Legislation, Guidelines and Statistical Collections

Supervisors should understand all aspects of the relevant legislation, prudential guidelines and the statistical returns. The institutions which are subject to supervision are your clients and they expect that you can justify your decisions.

With this in mind, it is therefore important that supervisors keep abreast of developments and undertake appropriate research into issues. The search engines on the internet make this a relatively easy task. It is also important that supervisors use their networks, for example other members of the Association of Financial Supervisors of Pacific Countries (AFSPC), to discuss issues such as reporting treatments for transactions or interpretations of supervisory concepts.

5. The New Supervisor

On joining a supervisory agency, a new supervisor should be given copies of:

- The legislation;
- The policy guidelines; and
- The statistical returns and instructions.

The new member of staff should be **assigned a mentor or trainer** to explain concepts and issues in greater depth.

Once the new supervisor has read all the documents and been assigned a bank(s) to supervise, he/she should be given a copy of the latest quarterly analysis and consultation material to review. In doing this the new supervisor will become familiar with some of the issues that arise from the process of bank supervision.

Supervisors should also give consideration to arranging attachments/secondments to financial institutions as part of a formal training program for supervisors, new and old. When considering such attachments, supervisors should prepare a terms of reference which addresses the areas that they would like to cover, e.g., credit risk management or investment risk management. To get the most out of these attachments, they should be of several months' duration and expose the officer to the day-to-day work of the area to which he/she is attached.

6. Some Early Warning Signs

Over the years, bank supervisors have noted a few indicators that may provide an early warning of serious liquidity and solvency problems in banks. The indicators listed below are not exhaustive. Analysts should be aware of them and, when necessary, should obtain the information required to carefully evaluate them.

Early warning indicators include the following:

- Relatively higher interest rate paid on deposits compared with the industry.
    - This suggests a struggle for liquidity
    - An attempt to grow too rapidly
- A significant change in the nature and composition of deposits.
    - Struggle for liquidity
    - Dependence on fewer and fewer depositors
- Difficulty of access to inter-bank funding;
    - Other banks usually have good information about their competitors through their own staff and customers.
- Resignations of board members.
    - If there are serious problems and the Board is being kept informed by management, some board members may decide to desert the institution in order to protect themselves, possibly from lawsuits or to protect their reputations.
    - Tension at the Board level also arises when an institution is having problems and this may lead to resignations.
- Management turnover

    - Management insiders may be aware of the significance of problems and may decide to distance themselves from a failing institution or to protect themselves by getting another job.
- Delays in financial and management reporting.
    - Analysts should carefully consider the lateness or inability of banks to file financial returns. This could indicate operating problems. The management of each bank must have accurate and timely information to run the bank effectively. In addition, reluctance to file reports may be an attempt to conceal problems from the supervisor.

7. Supervisory Action

If there are significant concerns about a bank as a result of deterioration of any of the key indicators of prudential soundness (e.g., capital adequacy, asset quality, liquidity or profitability, or the early warning indicators outlined above), the analyst should recommend a course of action to be taken by the bank to remedy the situation. Weak banks do not appear overnight. Problems that seem to emerge rapidly are often the sign of financial or managerial weaknesses that have been allowed to persist for some time. These problems can rapidly become a major concern to a supervisor if minimum prudential requirements are not met and viability is threatened. **The task of the supervisor is to identify these problems early, ensure that preventive or corrective measures are adopted, and have a resolution strategy in place should preventive action fail**.

The type of action that needs to be taken will be dictated by the circumstances. It is important that the Bank have a range of strategies to consider; the important thing is that action is taken promptly so as to limit any damage to the bank concerned and the banking system.

Such strategies could include:

1. Increasing capital – if the bank's capital levels and ratio are declining because of increased levels of business, losses or concerns about credit concentrations or weak risk management practices.
2. Requiring the bank to cease certain activities – if the supervisor is of the view that the activity is impacting the viability of the bank.
3. Conducting an on-site visit – should there be signs of deterioration in the bank's asset quality, or other aspects of its risk management, to determine the nature of the problem and what steps the bank is taking to resolve the problems.
4. Replacing management/board – if management practices are poor and resulting in a loss of confidence in the bank.
5. Selling assets – to increase liquidity and/or reduce pressure on capital adequacy.
6. Appointing the bank's external auditors to review aspects of a bank's activities.
7. Informing the public - if there are concerns in the market about a bank's ability to meet depositors' demands, the supervisor should, after satisfying itself that the bank concerned is not in any difficulties, issue a press release to assure the market that the bank has sufficient liquidity.
8. Selling the bank - arrange for the sale of the bank to other banks and thereby ensure an orderly exit from the market.

Supervisors should also develop a pre-determined list of remedies, which would provide a framework to help identify the range of options available when dealing with a problem bank. This would involve a hierarchy of remedial actions, ranging from the ability to set differential prudential standards, through the power to levy administrative fines and to require specific actions affecting management, leading ultimately to the power to revoke the bank's operating authorization and bring about the orderly winding-up of the institution. Remedial actions should reflect the provisions of the legislation.

Attachment 2 provides a list of remedies which should provide a framework to help identify the range of options available in dealing with problem banks. It outlines a hierarchy of remedial actions, ranging from the ability to set differential prudential standards, through the power to levy administrative fines and to require specific actions affecting management, leading ultimately to the power to revoke the authorization and bring about the orderly winding-up of the institution.

7.1 Revocation of a license

Revocation should be seen as the last action in the supervisory process. The need to revoke a license can arise following either a request from a licensee to revoke its license (as it is no longer conducting banking business) or in response to a licensee's failing to comply with directives. In some cases, the threat of revocation or fines may be enough to rectify the latter problem. The supervisor needs to ensure that she/he is on strong ground and has decided this course of action is appropriate.

Revocation is a serious matter and if the supervisor decides to revoke a license it cannot and should not be done lightly. The supervisor must be prepared to follow through; otherwise future directives will be ignored as licensees will know the Bank is not serious. Essentially, once the supervisor has "drawn the line in the sand" she/he must be prepared to act decisively. If the supervisor continues to move the line, it will not be taken seriously when it comes to dealing with other institutions or in relation to remedial actions.

7.1.1 A licensee requests revocation

In some cases, a bank may request that its license be revoked. The supervisor should only agree to such an action once it is satisfied that:

a. The licensee has repaid all deposits or made arrangements to transfer depositors' funds to another bank. (Typically it will arrange such a transfer if it cannot locate all depositors).
b. The licensee has discharged all liabilities to creditors;
c. The licensee has made arrangements for the transfer of remaining assets and liabilities to another entity – typically but not always another bank. The transfer of residual assets reflects that fact that not all assets can be liquidated (e.g., some long term loans) and these must be managed to maturity/repayment.
d. The licensee has ceased all forms of banking business.

The supervisor should seek confirmation from the licensee's external auditor that these issues have been satisfactorily addressed before agreeing to revoke a license.

7.1.2 Revocation by the Supervisor

In some cases, a supervisor may decide to revoke a bank's license. This action is likely to come about following the failure of the licensee to comply with either conditions placed on the license, legislative requirements or with directives issued by the Bank. Revoking a license should be seen as the last resort after having discussed issues with the licensee and having given it time to resolve/address outstanding matters.

In most cases a **key aspect of supervisory legislation is that the supervisor must give the licensee notice in writing that it intends to revoke the license**. This notice should clearly set out the reasons why it has been decided to revoke a license as legislation may give a bank the right to challenge the decision and seek its review by either the supervisor or in the Courts if the bank feels it has been denied natural justice.

A supervisor may be required to consider issues raised by the licensee before deciding if it will proceed to revoke the license. The supervisor may decide, after receiving comments from the licensee, that it will give the licensee another chance and impose conditions on the licensee. *While this may be valid in light of the concessions/undertakings provided by the licensee, the supervisor and licensee need to be very clear as to what will happen should the licensee fail to comply with any new conditions.* Basically, the supervisor cannot continue to extend the threat of revocation as it will lose its meaning if the market knows that the supervisor will not follow through. **Hence it is important that if the supervisor decides to commence revocation procedures that he/she is prepared to see them through**.

The licensee may also have the option to appeal the decision to the Court. Hence it is important that staff ensure that records are clear, e.g., there are diary notes/minutes of conversations between the supervisory agency and the licensee, that all correspondence is filed and, that the supervisor has complied with the legislative requirements. All of the supervisor's files (including emails) in relation to the licensee could be required to be produced in Court and it is therefore important that everything is on file and records adequately maintained. If the supervisor does not have such files, the likelihood exists that licensee will be successful in its appeal.

CHAPTER 2 – ASSESSING NEW APPLICANTS

1. Overview

Perhaps one of the most important aspects of bank supervision relates to the licensing of new entrants. This is the chance for the supervisor to ensure that only well managed and sound institutions can conduct banking business in the jurisdiction; it will not guarantee that a bank will not fail but if the barriers to entry are set sufficiently high it should ensure that only good banks operate in the market. The licensing stage is also when the supervisor has the best opportunity to extract undertakings or require improvements in risk management or other systems.

Typically in the Pacific, financial sector legislation outlines the information that is required to be provided by an applicant. In addition, in some jurisdictions there is an **information paper** or supplement that provides a more detailed outline of the information that should be provided by an applicant.

2. Assessment criteria

Applicants are expected to address the requirements of the legislation and other guidance material released by the supervisory agency. Supervisors should meet with applicants to discuss aspects of the application. It would be unusual for an applicant's first application to satisfy all of a supervisor's requirements; it will usually be necessary to ask the applicant to furnish revised drafts of the application until the supervisor is satisfied that the application contains all necessary information to understand all aspects of the new bank's operations.

Areas which require consideration include:

1. **Ownership** and **management** – is there evidence of financial capacity to support the bank should it experience problems and do the people running the bank have experience in banking? Are management and shareholders fit & proper? If the applicant is a branch/subsidiary of a large internationally operating bank which is listed on a stock exchange, it is difficult to determine whether shareholders are fit & proper. However, management should be and this can be checked. If a person who is to occupy a senior management position has worked in other parts of the bank overseas, the supervisor should write to the supervisor in that country and ask if they have information/concerns that might be relevant to your approval of that person as a senior manager/director. When considering the financial strength of the parent bank, the supervisor should review ratings agency reports and/or financial information such as annual reports.

2. **Projections** – are these realistic? Supervisors should ask to be provided with assumptions underlying the business plan. As a guide, if a new entrant is forecasting a net profit after the first year of business, the supervisor should be skeptical. Remember that this is a new entrant to the market and it will have a number of start-up costs (hiring staff, premises, equipment, etc.) and it will also be trying to capture market share from other participants. It is unlikely that it will capture a significant market share in the first year of operations and therefore its ability to generate income will be under pressure.

3. **Capital** – most legislation sets out the minimum capital requirement. Applicants should be encouraged to have capital in excess of the minimum to cover unanticipated costs/losses etc., which might arise especially during the first year of operations. More generally, it is prudent for a bank to hold a buffer above the minimum requirement. As part of the licensing process, the supervisor should obtain confirmation from the bank's external auditor that the capital is in place.

4. **Risk management systems** – should be consistent with the applicant's proposed business plan. Supervisors should be provided with information on the proposed bank's risk management systems and these should set out limits and controls in place. The systems should also detail reporting lines. If the applicant is a subsidiary or branch of a foreign bank, supervisors should understand the relationship between the local operation and Head Office, i.e., in terms of reporting lines and also the type of reports submitted to Head Office. The supervisor should also seek written confirmation from the bank's external auditors that the bank can produce all of the Bank's statistical returns.

5. **Foreign supervisors** should be approached in relation to the application. Even though the applicant is required to provide confirmation (e.g., a letter from the supervisor) confirming that it has no objection to the establishment of a branch/subsidiary in the local market, supervisors should make their own enquiries and liaise with the responsible supervisor in the home country. When the bank is licensed, the supervisor should formally write to the home country supervisor advising that the license has been granted and outlining what, if any, conditions have been imposed on the licensee.

3. Recommendations

Having reviewed the information, the supervisor is then required to make a recommendation that the license either be granted or refused. It is suggested that if the application is deficient and it appears likely that it will be refused, and this can be identified at an early stage, the matter should be discussed with the applicant with the aim of encouraging withdrawal of the application.

It is suggested that a memorandum recommending the granting/refusal of the license address each of the essential criteria outlined in legislation or other guidance material (e.g., ownership, business plan, capital requirements, etc.). Under each heading a brief summary of the key issues should be covered along with the supervisor's assessment that they feel management, risk management systems, etc., are adequate. Brief details of the business plan and economic benefits accruing to the jurisdiction should also be addressed. If any conditions are to be imposed on the license, these should also be highlighted. Confirmation of compliance with prudential requirements and, in the case of branch/subsidiary confirmation that the home country supervisor is agreeable to the bank's establishing an operation in your jurisdiction, should also be highlighted.

4. Start-up Letter

During the course of the application process, the applicant will be informed of a range of issues, e.g., prudential guidelines, statutory reserve deposit (SRD) arrangements (if applicable), minimum capital ratio, the supervisor's consultation and on-site inspection program, etc. It is therefore suggested that a "start-up" letter be prepared and given to the applicant on the day the license is issued. This letter should set out all the procedural and other requirements. It should also require the applicant to inform the supervisor of any material changes or substantive developments.

5. Arrangements with external auditor

During the application process, the supervisor should meet with the applicant's external auditor. The external auditor plays an important role in the on-going supervision of the bank.

Under most supervisory legislation, the auditor has an obligation to advise the supervisor if, during the course of the audit, any concerns are identified. Typically legislation also imposes fines on auditors who fail to comply with these and other provisions of the legislation.

In a number of jurisdictions tripartite arrangements between the supervisor, bank and external auditor exist.

CHAPTER 3 – MEETINGS & PRUDENTIAL CONSULTATIONS

1. Overview

This chapter focuses on meetings and prudential consultations; they are a very important part of the supervisory process. Such meetings with bank management or new entrants provide an opportunity for supervisors to discuss issues and concerns which arise from their supervisory work. Meetings are also important because they will in most cases be the forum in which the supervisory authority advises a bank that it is to take action in respect of breaches of requirements, decisions on key issues, or changes in the supervisory framework.

It is important that staff members representing the supervisor at meetings are, if possible, briefed on the issues to be discussed beforehand and that good and concise minutes of the meeting are taken by those attending. It is equally important that those who represent the supervisor at meetings are aware of a wide swath of issues to ensure that they can present other options/issues depending on the course of the meeting. **If in doubt, it is better to take the matter on notice or ask the other party to put the question in writing rather than making something up which may be wrong and commit the supervisory authority to something which could leave it exposed.**

2. Meetings

Meetings take many forms – some will be ad hoc in response to a request by a bank to meet with the supervisor to discuss general business issues (e.g., when a senior officer from Head Office visits the jurisdiction to pay a courtesy call on the supervisor). Others will be of a specific nature where a bank wants to clarify a particular issue or the supervisor wants to discuss an issue of concern.

2.1 Briefing for a meeting

Assuming the analyst is aware of the purpose for the meeting – and you should try to ascertain this – it is important that those representing the supervisory authority receive adequate and appropriate briefing. In some instances, a verbal briefing may be sufficient, and in some cases it may be necessary to liaise with other areas of the supervisory agency to get their input or to arrange for a representative from that department/division to attend the meeting.

Where specific issues are being discussed, e.g., where the supervisory authority has requested a meeting to discuss its concerns about a particular issue such as compliance with legislation or prudential guidelines, the background note for the meeting should include:

- The nature of the breach/issue;
- A short summary of actions taken to date; and
- A clear outline of the supervisor's concerns and its expectations to resolve the matter, including a deadline. (*These should have been discussed and agreed prior to the meeting, although depending on what the bank says during the meeting, the supervisor's message might need to be modified.* **Therefore it is important that those at the meeting have a clear understanding not only of the issues but of other options available depending on the course of discussions**).

3. Prudential Consultations

These are a very important part of the supervisory process and provide an opportunity for the supervisor to meet with an institution's management team to discuss a range of issues. Included in section 2.1 of Chapter One is an outline of the areas that should be included in the background note for a prudential consultation. Basically the background note for the consultation should be regarded as the opportunity for the analyst to prepare a complete picture of the institution's activities and operations for the past year and to highlight areas that should be focused on during the meeting.

Prior to the consultation, the analyst responsible for the day-to-day supervision of the institution should prepare a letter confirming the meeting and setting out an agenda identifying topics the supervisor would specifically like the bank to discuss. (Attachment 3 includes a sample letter).

3.1 Contents of the background note

As mentioned above, Chapter One includes a guide to areas to be covered in a prudential consultation background note. **The appropriateness of this list needs to be considered against the institution's operations,** but these key areas identified cover most operational aspects and the information necessary to be submitted to the supervisory authority.

Perhaps the key part of the background, especially for the reader who may not be as close to the institution as the analyst, is the **Executive Summary**. This should inform the reader:

- If there are concerns about the institution and, if so, what they are and your expectations for resolution.
- If there are any areas that need to be further explored with the institution and where you need/would like more information (e.g., new products, a change in strategy).
- If there are any outstanding matters that need to be raised with the institution.

The sections of the background note that deal with **data** (e.g., performance, capital adequacy) should present the picture of what has happened over the last 12 months. As with quarterly reports, this need not be a blow-by-blow account of movements each quarter; rather, the analyst is reporting on trends and emerging issues identified by the data. Sections that deal with issues such as **Risk Management** and **On-site inspections** should focus on key changes to risk management systems and what steps the institution has taken to address issues identified during an inspection.

Attachments to the note are important and should include, but are not limited to, the following:

- A copy of the agenda sent to the institution.
- A copy of the minute of the previous consultation.
- A copy of standard statistical tables (e.g., capital adequacy, large exposures).
- A copy of the letter sent to the institution in relation to an on-site inspection.
- Copies of relevant press cuttings.

4. During Meetings & Prudential Consultations

In most cases the meeting will be chaired by a senior officer from the supervisory agency. However, that officer should be prepared to involve the responsible analyst when discussing some specific issues. In most cases it is probably best if the supervisory agency is represented by at least two officers, one of whom should take notes of the meeting and prepare a diary note for circulation/records. During the meeting you should ask for clarification of issues if not sure about an issue discussed.

5. Minutes of meetings & consultations

As discussed in Chapter 1, minutes of meetings should be clear and concise, and while they do not need to record everything said during a meeting, they should summarize key points discussed, particularly a response to an issue raised by the supervisor. **Remember, the minutes of meetings are important as they are a record of discussions and may need to be used as the basis of supervisory action or as part of a court case against a bank.**

Minutes of meetings should be written as soon as possible after a meeting. The main reason for doing so is basically so that the matters discussed are fresh in your mind. It becomes more and more difficult to remember things that were said as time goes by. In addition, the meeting may have been on an important issue that requires action by the supervisor or a follow-up letter to be sent.

More generally, it is important to remember when writing diary notes, particularly of **prudential consultations,** that the note is to be sent back to the institution's senior management as a record of the meeting. **Therefore the diary note should be more than just a summary of management's presentation to the supervisor. The note should summarize key issues discussed during the meeting, e.g., strategy, asset quality, performance, etc., and key issues raised by the supervisor and the institution's response.** There is no point sending the bank back a summary of its presentation to the supervisor.

A practice that could be implemented is one where the analyst writes a **short note** of, say, 2-3 pages in length that is a summary of key points. **This note should be completed within one week of the meeting.** The note should then be forwarded to the institution for its comment before finalization. The analyst could also prepare a **long/more comprehensive note** which is a more in depth summary of the meeting and all issues discussed for record. More generally at meetings where presentations/handouts are given it is not necessary to summarize the points made in the handout – this can be attached to the diary note. **The important thing is to record the key issues/points made at the meeting.**

5.1 After the consultation

After the consultation, the short note of the meeting should be forwarded to the institution to allow it to correct any **factual errors**. Requests by the institution to change any messages/concerns raised by the supervisor should be rejected. When the minute is finalized it should be sent to the Managing Director/CEO and he should be requested to forward a copy to the institution's board or Head Office management. In some cases, the supervisor may decide to send the material directly itself, rather than leave it to chance.

CHAPTER 4 – OFF-SITE ANALYSIS FOR BANKS

1. Overview

This chapter outlines key issues to be considered when reviewing statistical and prudential data submitted by domestic banks. While some particular aspects are discussed in this chapter, it is important to note that these are **examples** and that supervisors must be constantly considering movements in a number of data and ratios. Over time, therefore, it may be appropriate to change the focus of analysis to consider other movements.

Where appropriate, references are made to legislative or other requirements which must be complied with by banks. Linkages between the various statistical returns should also be considered.

Each section also incorporates a discussion of relevant risk management issues.

2. Balance sheet information

Typically banks are required to submit a number of statistical returns to the supervisor on a monthly or quarterly basis. The most standard set of returns cover Liabilities/Assets and Loans and Advances Classified by Sector. The returns provide information of various balance sheet items and in some cases items are also split between local and foreign currency amounts or between residents and non-residents.

2.1 Liabilities

Such a return should provide detailed information on the composition of a bank's liabilities and, as mentioned above, it may also provide further detail by currency or residency. Supervisors should consider the composition of a bank's deposit liabilities and movements in the major categories, i.e., demand, savings and fixed deposits.

Consideration should also be given to the growth of deposits. If the rate of growth is high relative to the banking industry, the reason should be ascertained; it is likely that the bank is paying a high interest rate on its deposits or has launched a fund raising campaign. If so, why?

Banks routinely engage in transactions on behalf of clients or for their own account which are not reported on-balance sheet but which nonetheless expose the institution to credit or other forms of market risk. In certain cases such as letters of credit, an institution in effect substitutes its credit standing for that of clients. This enables clients to conduct business with third parties with whom these clients may have an insufficient track record. The bank thus guarantees the performance of its clients, and while it does not initially provide funds, it nevertheless exposes itself to the risks of having to provide cash, and thus create a loan should the client fail to perform vis-à-vis its counterpart. These transactions are generally kept **off-balance sheet**. Analysts should also review movements in **off-balance sheet** instruments.

2.2 Assets

As with a data collection focusing on liabilities, the asset return should provide detailed information on the composition of a bank's assets and, as mentioned above, it may also provide further detail by currency or residency. As with liabilities, supervisors should consider movements in the major asset items. However, while some items may show strong growth, it is important to take into consideration the risk associated with this growth. For example, increased holdings of cash is not a concern (although it will impact profitability as holding cash will not earn income; likewise increased balances with the central bank are not a concern as these could be related to Statutory Reserve Deposit obligations). Areas that should be focused on include the types of claims on the private sector and claims on non-residents.

An important area that should be considered is the rate of growth of a bank's assets. If a bank is showing a very fast rate of growth relative to its peers and the banking system, consideration should be given to the adequacy of its risk management systems and management to cope with the growth. In this regard, what could be occurring is that, in a bid to increase market share, the bank is writing marginal loans, i.e., it is sacrificing its credit standards to grow its book. While this may result in increased profitability in the short term, the bank is likely to experience problems in the longer term as the level of bad and doubtful debts increases.

2.3 Loans and Advances Classified by Sector

This return, if the supervisor collects such information, provides more in-depth information on the composition of a bank's loans and advances. Totals on this return should be equal to loans and advances on the asset return. It is recommended that where supervisors do not collect this information, consideration should be given to introducing such a statistical collection as these data provide greater insight into a bank's exposures and potential problems if the economy, or a specific sector, experiences a downturn. Another option would be to ask banks to provide copies of internal reports which provide information on asset classifications.

Analysis of this return should focus on the top 5 to 6 sectors – the situation will need to be monitored as a bank's **strategy** changes. It is useful to graph 12 months of data to determine the trend. The return also enables the supervisor to identify or confirm changes in a bank's lending strategy.

It is important, especially for items such as "personal" lending, that supervisors drill down into the data and look at the composition of personal lending. This sector includes housing finance and other personal finance (e.g., school fee loans, finance to buy goods/cars) so it is important to understand which component is driving movements in personal lending.

2.4 Profit and Loss

Earnings are of critical importance for a bank. Firstly, they are the source for internally generated capital. Without internal capital generation a bank will find it difficult to grow and maintain adequate capital. Secondly, earnings determine the ability to attract additional capital - either from existing shareholders or entirely new ones. Thirdly, earnings help crystallise the bank's reputation in the market in which it operates. Fourthly, earnings are essential to absorb credit losses.

The objectives of monitoring earnings are to:

- Assess the quality, sustainability and volatility of earnings;
- Compare with industry and peer groups;
- Analyse the major components of earnings; and
- Determine the trend.

Supervisors should consider the source of a bank's income and the key drivers of performance. A concept to focus on is a bank's "underlying profit, or the profit made from being in the business of banking. Underlying profit is:

Net interest income +
Other operating income -
Operating expenses =
Underlying profitability

Underlying profitability removes the impact of the charge for provisions for doubtful debts which can sometimes, depending on their size, impact a bank's 'bottom-line' profit.

3. Capital Adequacy

3.1 Overview

Capital adequacy is a key determinant of the financial condition of a bank. In the final analysis capital represents, for the depositors, the last line of defence against loss. The supervisor should review recent trends in the capital ratios and their current level relative to supervisory standards.

The objectives of monitoring capital are to:

- Assess the capital adequacy of the bank;
- Compare the adequacy with statutory requirements;
- Evaluate the trend of capital adequacy;
- Assess the composition of the capital base - that is, the significance of Tier I and Tier II capital and the various components; and
- Assess the ability of the bank to generate capital internally.

In addition, a bank's capital resources should be measured against other data. For example, the size of a bank's impaired assets less specific provisions should be considered relative to a bank's capital base. This ratio will give you an idea of the extent a bank's capital can absorb a loss and still meet the minimum capital adequacy requirements.

3.2 Statutory and other requirements

There are a number of requirements on banks in regards to capital adequacy and these are included in legislation and prudential guidelines.

1. **Minimum capital requirement**.

2. **Minimum capital ratio** – the supervisor under legislation has the power to set a minimum capital ratio for a bank. Consistent with international banking standards

determined by the Basel Committee on Banking Supervision, the minimum capital ratio should be set at 8 per cent. However the supervisor has discretion to set a higher minimum requirement and should do so especially in the case of a new bank or a bank that operates in a more risky sector of the market.

3. **Both the minimum capital requirement and the minimum capital ratio** are to be met at all times.

4. **At least** 4 per cent of capital resources are to be in the form of Tier 1 capital instruments.

5. **Tier 2 capital** cannot exceed Tier 1 capital.

6. **General Reserve for Credit losses** may be included in Tier 2 capital up to a maximum amount of 1.25% of risk-weighted assets.

7. **Goodwill** and similar intangibles are to be deducted from Tier 1 capital.

8. **Dividend payments** cannot exceed the current year's earnings. (The supervisor may, in exceptional circumstances, approve such payments if it is satisfied as to the bank's capitalization and ability to meet prudential requirements).

3.3 Analysis

As suggested in section 3.1 above, the analysis should consider **trends** in a bank's capital ratio and the factors behind movements in the ratio. Has there been a change in the level of **capital resources** and if so why?: e.g., payment of a dividend, a loss over the quarter, an increase in paid-up capital. Have **risk-weighted assets** increased or decreased? Movements in **retained earnings** should reflect payments of dividends, and profit and losses made over the quarter. (It should be possible to reconcile movements in retained earnings with profit/loss and provisioning data reported on any Profit & Loss returns).

It is useful to present capital trends in graphs. It is suggested that graphs should show 5 quarters of data and include capital ratios(Tier 1 & Total) and the level of risk- weighted assets.

When looking at trends, and in particular downward trends in capital ratios, it is important that the analyst make **forecasts** on the future position. An easy way to do this is using Excel. Simply highlight the last 5 quarters of risk-weighted assets and total capital and drag the cursor forward over a few columns and Excel will calculate the next numbers in the sequence based on the earlier data. Then divide capital by risk assets and you have a forecast. The method maybe crude but it will highlight a trend and provide the supervisor with an idea of a bank's likely capital position and needs.

As noted, trend analysis is important. If a bank's capital ratio shows a continued decline over several quarters and the ratio is nearing the minimum you need to commence discussions with the bank to ascertain how it will remedy its capital position. Remedial actions could include increasing capital, slowing balance sheet growth, selling assets or a combination of these measures. **It is important to note** that, as a supervisor, you should set trigger ratios. If a bank's capital ratio has fallen to say 10% (minimum 8%), the situation should be monitored closely and an action plan developed. Should the ratio fall to 9% then discussions with the bank's management should be initiated. In setting these trigger ratios consideration should be given to the trigger ratios contained within a bank's **capital management plan.** Prudent bank managers/boards should have in place trigger ratios for capital (and other indicators, such as liquidity) which, when breached, require management action.

More generally, when discussing capital and liquidity, **bank management should have a buffer above the required minimum to enable the bank to the deal with unexpected shocks**. A range of factors need to be considered when determining the size of a buffer. For example, if a bank has a high level of impaired assets for which there are no specific provisions, supervisors need to consider the potential impact on the bank's capital position should all of its impaired assets be written off and the bank suffers significant losses. The bank's capital will be depleted as it must write off the loans, and such write-offs could see the bank's capital/capital ratio fall below the required minimum.

4. Loan Classification (Asset Quality)

4.1 Overview

Banks provide funds or commit to provide funds to customers. In turn the customers are obliged to repay the amounts borrowed plus fees and interest. (This applies to both on- and off-balance sheet obligations). Experience indicates that good credit quality goes hand in hand with financial soundness. An early warning of a troubled bank is often the detection of a decline in the quality of credit.

The size of bank's non-performing or impaired assets net of specific provisions as a percentage of capital is an important indicator. Put simply, if all of the bad loans went bad and the bank did not have sufficient specific provisions (and general provisions) to cover the losses, then the bank would be required to write losses off against its capital. The bank's capital position relative to minimum requirements could be affected. Of course, the size of the loss might be reduced through the sale of any security held by the bank. However, the sale may take some time to arrange.

Another important factor that should be taken into account when assessing a bank's asset quality is the level of provisions. Typically banks have two types of provisions in relation to asset quality[1]:

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[1] The introduction of International Financial Reporting Standards (IFRS) will change existing accounting standards in relation to the recognition and measurement of assets, liabilities, equity, revenue and expenses and **supervisors should review their statistical and prudential collections to take these changes into account as banks adopt the new standards** in consultation with other banks and accounting bodies. The main accounting changes of most interest to banks are:

- more restrictive requirements for capital instruments to qualify as equity;
- more stringent rules governing removal of financial assets from the balance sheet and a broader capture of entities that may be required to be consolidated, such as securitization vehicles;
- recognition of all derivative financial instruments on the balance sheet and measured at fair value. In addition, comprehensive hedge accounting requirements will be introduced;
- restrictions on the recognition of general provisions; and
- change in the measurement basis of financial assets and financial liabilities.

In the case of **general provisions**, IFRS will require provisions for impairment to be recognised on an incurred and incurred-but-not-reported basis. This broadly means that provisions for impairment must be based on loss

1. **General provisions** are created against future, presently unidentified losses, and must be freely available to meet any losses which might subsequently materialize.

2. **Specific provisions** are created against problem exposures. As a general rule, where there is doubt about the collectibility of a loan, and security exists, specific provisions should equal the face value of the loan less the net current market value of the loan.

In the north Pacific (Marshall Islands, Micronesia and Palau) banks report an allowance for loan losses and banks are expected to maintain this allowance through charges to provision expense in the income statement and maintained at a level adequate to absorb potential and expected losses in the loan portfolio and in respect of other assets.

The objectives of monitoring the bank's credit portfolio are to:

- Assess the quality of credits, both on- and off-balance sheet;
- Compare its asset quality, using key indicators, with its peer group;
- Evaluate the trend in credit quality - that is, determine whether it is improving, remaining the same or deteriorating;
- Assess the composition of credits, by industry, currency, related parties, insiders, and security held to determine whether any significant concentrations are present; and
- Assess the adequacy of provisions for credit losses.

4.2 Analysis

On a quarterly basis, banks should be required to submit a loan classification return. *At a minimum, loans should be split into four categories which should align with banks' internal ratings systems*. It is useful, especially prior to an on-site inspection, to ask the bank to map its loan grading into the four categories used by the supervisor, i.e. grades 1 – 5 are standard, 6 -7 substandard (sometimes also called "watch list" loans), 8 – 9 doubtful and 10 – loss. The following provides some guidance on the categorizations that could be used as a starting point for collecting and analyzing the data. Banks may develop their own internal risk grading system to indicate various levels of risk exposure in assets; however, such risk grades should be reconciled to the five regulatory categories detailed below.

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experience and only recognised after an event on which the loss experience is based has occurred. This is a departure from current practice under which general provisions may be recognised where impairment is considered probable.

IFRS also contrasts to supervisors' general provisioning model and prescribed provisioning requirements contained in supervisory guidelines on the subject of loan classification and provisioning for impaired assets, which are structured on an expected loss basis. Accordingly, the adoption of IFRS may require banks to write back general provisions and some prescribed provisions recognised in accordance with supervisory guidelines in their financial statements.

IFRS requires provisions for impairment to be recognised on an incurred and incurred-but-not-reported basis. Hence, it allows specific provisions for impairment on loan portfolios but not general provisions for expected but not incurred losses. Banks may therefore need to reclassify a portion of general provisions as specific provisions (if they are raised to cover incurred and incurred-but-not-reported losses) and/or release the excess provision into retained earnings. This is in effect a reclassification of Upper Tier 2 capital to Tier 1 capital on IFRS adoption, which has prudential implications.

(1) **“Pass”** if the asset is fully protected by the current sound worth and paying capacity of the obligor, is performing in accordance with contractual terms and is expected to continue to do so;

(2) **“Special Mention”** if the asset:

i. is past due for more than 30 (thirty) days but less than 90 (ninety) days;

ii. although currently protected, exhibits potential weaknesses which may, if not corrected, weaken the asset or inadequately protect the bank’s position at some future date, for example –

- the asset in question cannot be properly supervised due to an inadequate loan agreement; or
- the condition or control of the collateral for the asset in question is deteriorating; or
- the repayment capacity of the obligor is jeopardized because of deteriorating economic conditions or adverse trends in the obligor’s financial position; or
- there is an unreasonably long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset:

provided that, generally an asset shall be classified Special Mention only if its risk potential is greater than that under which is was originally granted;

(3) **“Substandard”** if the asset:

i. is past due for more than 90 (ninety) days but less than 180 (one hundred eighty) days; or

ii. is required to be placed on non-accrual status;

iii. is a renegotiated loan which has had its terms or interest rate modified because of weaknesses or deterioration in the obligor’s financial condition or ability to repay, unless all past due interest is paid by the obligor in cash at the time of renegotiation and a sustained record of timely repayment of principal and interest under a repayment program, where such repayment terms and rate of interest are consistent with other loans being made by the bank at the time of renegotiation and in accordance with guidelines as outlined in the Board-approved loan policy, has been demonstrated for a period of not less than six (6) months; or

iv. whether or not it is past due, is inadequately protected by the current sound worth and paying capacity of the obligor by reason of the fact that:

- the primary source of repayment is insufficient to service the debt and the bank must look to secondary sources such as collateral, sale of fixed assets, refinancing or additional capital injections; or
- there is an unduly long absence of current and satisfactory financial information or inadequate collateral documentation in regard to the asset; or

- generally, there is more than a normal degree of risk attaching to the asset due to the obligor's unsatisfactory financial condition;

(4) **"Doubtful"** if the asset:

i. is past due for more than 180 (one hundred eighty) days but less than 360 (three hundred sixty) days; or

ii. exhibits all the weaknesses of a substandard asset and, in addition, is not well-secured by reason of the fact that collection in full, on the basis of currently existing facts, is highly improbable, but the actual amount of the loss is indeterminable due to pending events that have a more than reasonable prospect of mitigating the loss, such as a proposed merger, acquisitions or liquidation, a capital injection, perfecting liens on additional collateral, refinancing plans, new projects or asset disposal;

(5) **"Loss"** if the asset:

i. is past due for more than 360 (three hundred sixty) days, unless such asset is well secured and legal action has actually commenced which is expected to result in the timely realization of the collateral or enforcement of any guarantee relating to the asset; or

ii. had been characterized as Doubtful on account of any pending event referred to in subparagraph (4)(ii) above, and the event concerned did not occur within 360 (three hundred sixty) days, whether or not the event is still pending thereafter; or

iii. is otherwise considered uncollectible or of such little value that its continuance as an asset on the books of the bank is not warranted:

provided that a Loss classification shall not preclude the possibility of recovering the asset or securing a salvage value for it.

Supervisors should also require that assets be categorized as non-performing and be placed on non-accrual status if any of the following conditions exist:

(1) any asset, but excluding overdrafts, when:

i. principal and/or accrued interest is due and uncollected for 90 (ninety) days or more beyond the scheduled payment and/or maturity date; or

ii. accrued interest equal to 90 (ninety) days or more has been capitalized to the outstanding principal balance of the obligation, refinanced, or rolled-over, and full repayment of principal and/or accrued interest is not expected as evidenced by a well-documented written analysis and evaluation of the obligor's current financial condition; or

iii. payment of principal or interest in full is not expected based upon either an analysis of current financial information on the obligor or other reliable information or facts:

provided, installment loans on which payments are due and unpaid for 90 (ninety) days or more are not required to be placed on non-accrual status. Nevertheless, such loans will be expected to be subject to other alternative methods of evaluation to assure that the bank's net income is not materially overstated;

(2) overdrafts which carry a debit balance for 90 (ninety) consecutive days or more;

(3) the asset is classified Doubtful or Loss.

In addition, banks should be required to report information on restructured items and non-accrual items, write-offs and recoveries over the quarter and information on past due loans greater than 90 days and 180 days. Banks should also be required to report information on specific provisions and security held against such exposures.

When reviewing data, consideration should be given to the following issues:

- **Changes** in the composition of asset quality, i.e., has there been a significant fall in asset quality which is reflected by increased levels of substandard and doubtful loans? Trends in data are best viewed in a graph showing five quarters of data.
- The level of **non-performing loans** less specific provisions relative to capital.
- The level of **non-performing loans** to total assets.
- The level of **specific provisions** and **security coverage**.

Should there be a significant deterioration in asset quality over the quarter, the analyst should contact the bank concerned to ascertain the reason for the decline in asset quality and to understand the bank's position, i.e., does the bank feel that it is well protected through adequate security or is the bank looking to implement an exit strategy? In either case the analyst should make sure that full details are provided and changes in asset quality and other details are promptly provided to senior management.

When making enquiries of the bank, the analyst should also ask if this is a one-off problem (e.g., a hotel that cannot service its debt) or if the bank is seeing similar problems with other exposures in its portfolio (e.g., tourism). If it is a concern across a sector/portfolio, the supervisor should look at all banks' exposures across the sector and ask them if they are experiencing any concerns. If the supervisor is aware that other banks have an exposure to the same entity, it worth checking to see if they are experiencing any concerns and if they are treating it in a similar manner. (In some cases one bank may consider an exposure impaired while another bank may not. It is important to understand why. For example, the second bank may have better security or a greater understanding of the client's position.) *Care must be taken here and the issue should only be discussed with other banks if the matter is in the public arena.*

It is also important to understand the reasons for significant movements as such declines could trigger an on-site inspection if there are widespread concerns about a bank's asset quality and credit risk management systems.

The level of past due loans should also be monitored. The normal requirement as outlined by Basel is that loans should be classified as a non-performing credit as one on which interest and/or principal is 90 days or more past due. With regard to such credits, banks are required to cease accruing interest and to make a determination as to whether a provision for loss is required. The ratio of non-performing credits to total credits establishes the percentage of the credit portfolio that is experiencing problems. A high ratio may indicate significant future provisions for credit losses or write-offs. Those factors will cause the bank to suffer a reduction in earnings and cash flow. Over time, significant write-offs and reduced earnings will erode a bank's capital base.

Exposures past due 180 days are hard-core non-performing credits. Typically there will be specific provisions held against such loans and banks will be seeking to exit the exposure by writing them off after having taken all steps to cover/improve their position so as to minimize any loss.

Restructured items are those loans where the original contractual terms have been modified to provide for concessions of interest or principal for reasons relating to financial difficulties of the borrower. There should be new terms and conditions for the loan. **Movements in restructured items should be monitored to ensure that a bank is not trying to disguise the true state of its loan portfolio**.

When reviewing the non- performing loan return it should be possible to cross-check movements in levels of provisions (specific and general) and write-offs and recoveries against the quarterly profit and loss return.

5. Large Exposures

5.1 Overview

Banks are in the business of lending money. The issue for bank supervisors arises from concentration of exposures, either to one borrower, a group of related borrowers or a particular sector of the economy.

Supervisors should impose a limit on a bank's exposures to a single customer or group of related customers[2]. Most supervisors in the region have imposed statutory requirements which limit such exposures to 25% of a bank's capital. In some cases, legislation gives the supervisor discretion to approve exposures above the 25% limit. It is suggested that the discretion should only be used in **exceptional** circumstances. In this regard two situations could arise where a bank wants to exceed the 25% limit:

1. A financing proposal that is related to country's infrastructure (e.g., building new power generators) where the size of the project is significant. In such cases, the supervisor should seek full information on the exposure (e.g., term, facility structure, security). In the case of a subsidiary bank, the supervisor should seek support, in the form of a **guarantee** from Head Office that, should the local bank experience a loss, it (Head Office) will ensure that local bank continues to comply with the supervisor's requirements in relation to capital adequacy; and

2. Where a facility is denominated in foreign currency and the local currency depreciates against the foreign currency. This means that the value of the facility when converted to local currency increases and this could result in the exposure exceeding 25% of the bank's capital. In such cases, the supervisor should ask what the bank is doing to reduce the exposure – in some cases the bank may ask the borrower to reduce the facility. There should be an agreed timeframe to get the facility back within the 25% limit.

[2]Refer to Basel Core Principle 10.

While the 25% limit is important, supervisors also need to consider the issue of **lending concentrations** more generally.

1. A bank which has a large number of exposures in excess of 10% of capital could experience difficulties if a number of these became impaired. Accordingly, it may be appropriate to consider imposing a higher minimum capital requirement on a bank in this position.

2. Exposures to an industry, geographic area or sector should also be subject to limits. While it is not recommended that a supervisor impose limits, **banks have such limits in place**. The reason for such limits, especially geographic, may not be apparent; however, experience in other countries has shown what can happen if a bank has exposure concentrations. For example, a bank may have a number of housing loans in one area to borrowers all employed in one particular industry. On the face of it, the bank might consider itself as having a well diversified home loan portfolio. However, if all the borrowers are employed by one employer or dependent upon one market (e.g., mining or hotels) which collapses, the bank suddenly has a problem.

Some exposures are excluded from the limit. These essentially fall into two categories: exposures which are cash collateralized and inter-bank exposures. In the case of cash collateral, the bank must have a legally binding agreement that, in the event of default by the borrower, the bank can **automatically** access the cash and offset it against the exposure. Hence a loan that is **fully** cash collateralized receives a zero risk weight. Inter-bank exposures are also excluded, although it should be noted that in some jurisdictions, supervisors are looking to impose limits on the size of such exposures.

5.3 Analysis

When reviewing a bank's large exposures, it is suggested that supervisors consider trends and therefore graph the total level of large exposures relative to capital. Banks should be required to report information on the amount outstanding and the size of the facility. If a bank's exposure exceeds the size of the facility, the bank should be questioned as this may represent a breach of an approved limit.

As noted in section 5.2 above, consideration should also be given to the number of exposures and the size of exposures relative to the bank's balance sheet.

Where a bank has a high concentration of large exposures relative to capital, this should be discussed with bank management during the course of the annual prudential consultation. In addition, it would be appropriate to review these exposures during an on-site credit inspection.

6. Large Deposits

In some jurisdictions, banks are required to submit information on their largest deposits. Even if they do not, banks should be monitoring their deposits for liquidity management purposes.

The primary purpose of collecting this information is to enable a supervisor to form a view about a bank's susceptibility to liquidity risk. If a significant proportion of a bank's funding is sourced from a few large depositors, the bank could be exposed to liquidity problems should the depositor move its deposits to another bank.

Analysts should consider the size of the largest deposits against a bank's total deposit base and in the context of a bank's liquidity policy. A bank's liquidity policy should provide guidance as to the limits a bank has in place for limiting the concentration in funding sources to avoid excessive reliance on any one counterparty (including related counterparties), product or market.

7. Maturity Profile

7.1 Overview

Liquidity, simply stated, is the ability of the bank to meet its obligations on time. This relates particularly to deposit liabilities. If a bank is unable to meet these demands, its continued existence could be threatened. Liquidity risk arises from fluctuations in the bank's cash flows. The risk of illiquidity increases if there is a significant mismatch of principal and interest cash flows and maturing liabilities.

Some jurisdictions collect a quarterly maturity profile return which requires banks to categorize their assets and liabilities by maturity – in some cases, banks are required to estimate maturity or cash flow if there is no contractual arrangement.

Ideally a bank should aim to have a square or slightly positive mismatch between assets and liabilities out to five days.

7.2 Analysis

Analysts should consider trends in the maturity mismatches with particular focus on the shorter time bands. If the mismatches are negative, i.e. liabilities exceed assets, and increasingly it is appropriate to ask the bank how it intends to cover these mismatches, e.g., access to a stand-by line of credit or funding from Head Office. Consideration should also be given to the size of mismatches relative to the bank's total liabilities. As banks are required to have in place maturity mismatch limits, data submitted to the Bank should also be checked against the limits specified in the bank's liquidity policy.

When reviewing the maturity profile return, it should be possible to perform a quick accuracy check as the data reported on this return should equate to items on the bank's Form 1 and Form 2.

Analysts should also consider arrangements covering **commitments to lend funds** and how banks have treated these for liquidity management purposes. Similarly, consideration needs to be given to the extent to which a bank relies upon **standby lines of credit** from other banks. If a bank is overly reliant on such funding, analysts should understand the nature of the facility and whether it is committed, i.e., is the bank paying a fee?

The instructions to the *Maturity Profile Return* provide more information on how various assets and liabilities should be treated.

8. Liquid Assets Requirement

A number of supervisors impose a minimum liquidity requirement. Under these arrangements, a bank is required to hold at all times a minimum stock of its assets in certain high quality readily liquefiable assets. This provides a stock of cashable, undoubted assets which, with the supervisor's approval, can be *quickly* converted into cash in extreme circumstances. Such stock **is additional** to the liquid assets which each bank holds for management of its day-to-day liquidity needs.

8.1 Analysis

Analysts should monitor trends in the liquidity ratio. If the ratio has been declining for a number of weeks this may indicate that the bank is experiencing liquidity problems and may not be able to raise deposits or other funds in the market.

In the event that a bank breaches the minimum requirement, the bank should be required to provide a written explanation of the circumstances surrounding the breach and of measures taken to ensure that it does not happen again.

Analysts should also be aware of the bank's own internal policy requirements as these may require the bank to maintain a buffer above the minimum requirement. Therefore a breach of the buffer, but not the minimum LAR requirement, is a breach of a bank's internal policy that needs to be investigated.

9. Country Exposures

Basel Core Principle 12 requires that banks be able to monitor and control their country risk. The purpose of a country exposure return is to provide information on banks assets/claims outside the jurisdiction and those claims, either within the jurisdiction or elsewhere, which are supported by a non-resident, e.g., through a guarantee.

Such a return requires banks to report all loans to and deposits with parties outside the jurisdiction, including claims guaranteed by residents of third countries. The reason for monitoring these data is that, in some circumstances (e.g., introduction of exchange controls which limit the outflow of funds from the country to the jurisdiction, or political and economic uncertainty), it may be difficult for the bank to obtain its funds from borrowers resident in other countries. Banks should also be required to have and report details of country limits.

9.1 Analysis

Analysts should monitor exposures to individual countries. In particular, analysts should raise concerns with banks where:

- A country to which a bank has exposures undergoes some structural change, e.g., introduction of exchange controls or severe economic crisis, which will impact the ability of the bank to obtain its funds;
- A country (or group of countries) which experience economic problems (e.g., the Asian Crisis); or
- A bank's level of exposure to a country exceeds the limit reported to the supervisor.

Analysts should also understand the nature of a bank's country exposures, i.e., do the exposures arise through the placement of funds on deposit with overseas banks or through direct lending to counterparties domiciled overseas?

10. Equity Associations

10.1 Overview

Banks should be required to report information on their equity investments. Equity investments can arise through investments in subsidiaries and associated companies, as part of a bank's overall investment strategy, and can arise if a bank is required to take shares in a company as part of a settlement of a non-performing loan. Equity investments can expose a bank to different risks than those associated with lending and, as such, limits are imposed on the level of a bank's equity investment. The most significant risk facing a bank with equity investments is that the value of the equity falls and the bank, if it is not able to sell its holding, will suffer a loss. This is different to lending, where depending on the nature of the facility and security, the bank may be able to limit its loss and recover funds through the enforcement of security.

CHAPTER 5 – ON-SITE INSPECTIONS FOR BANKS

1. Overview

This chapter focuses on the role of the supervisor in relation to on-site inspections. The chapter reviews all aspects of the visit from planning for the visit to after the visit follow-up.

This chapter will cover on-site work in the areas of: **Credit Risk Management, Anti-Money Laundering**, **Operational Risk** and **Liquidity Risk.** In general, there is little difference in planning and conduct of these visits and differences will be highlighted as appropriate.

It is important to note that discussions with banks should not be limited to these visits, topics or the timing suggested in section 3 below. Supervisors should be pro-active in looking to discuss issues with banks that arise from off-site analysis of data and other information.

One of the main aims of on-site work is to check that banks are in actual fact complying with not only the supervisor's guidelines but also their own internal policies and procedures. These visits will also enable the supervisor to d**etermine if a 'compliance culture' exists within the bank**.

2. Statutory power to undertake inspections

It is essential that supervisory legislation give the supervisor the power to undertake on-site examinations of supervised entities. In most cases, the legislation also provides for the supervisor to use a consultant or an expert to either undertake the examination or provide assistance.

In instances where foreign supervisory agencies wish to undertake inspections of banks licensed, it is recommended that local supervisors participate in such inspections. This will provide them with the opportunity to share information and improve their supervisory techniques. The involvement of the foreign supervisory agency will also need to be discussed with the bank concerned.

3. Timing and scope of visits

Typically visits should be conducted every two years – this means that there will be an inspection to a bank every year. In year one the focus of the visit could be AML and in the next year credit risk management.

The two year cycle is only a suggestion. There will be occasions when the frequency of visits is increased reflecting concerns about aspects of a bank's risk management systems. Similarly, if no particular concerns are identified with a bank it may be appropriate to delay a visit to allow supervisors to concentrate resources on a bank which is giving rise to concern.

4. Pre-visit planning

Pre-visit planning is crucial to the success of the supervisor's on-site work. For on-site work to be of maximum benefit to the overall supervision of a particular bank, it is important that the process be tailored as much as possible to meet the needs of the supervisors, as they are responsible for the overall assessment of the bank. To do this, it is important that thought is given to the following issues at an early stage:

- **Bank specific issues:** are there any particular issues or concerns about the bank to be visited (e.g., lending concentrations, deposit concentrations, provisioning policies, lending standards)?
- **Available information:** what is already known about the bank and in what areas is more information needed?
- **Internal planning considerations:** does the timing of the visit fit with other supervisory activities (e.g., consultations), and are there any specific issues that need to be incorporated in the planning the visit?

At an early stage, a preliminary briefing note should be prepared to highlight issues relevant to the on-site inspection.

When the dates for the on-site inspection are agreed with the bank concerned, the analyst should prepare a short briefing note (1 – 2 pages) outlining the activities of the bank and any particular outstanding issues or concerns relevant to the bank. This note can form the basis against which much of the structure of the visit can be planned and it is therefore useful for it to be completed as soon as possible after the dates for the visit are confirmed and **at least two weeks** prior to the commencement of the visit. The analyst should also compile relevant background material for the visit, e.g., latest available risk management systems description and details of non-performing/impaired assets.

4.1 Content of the briefing note

The briefing note should, at a minimum, include the following information:

- An overview of the bank's strategy and target market. This information is useful in determining whether or not a bank's management has the relevant credit assessment or other skills. This information also serves to provide an outline for discussions with the bank's management at the opening meeting[3].

- Information based on statistical information provided to the supervisor by the bank:

  - Trends in liabilities and assets;
  - Main concentration of claims, e.g., is the bank primarily lending to business, individuals and households, or others?;
  - Review of significant sectoral exposures, e.g., construction, tourism, personal lending;
  - Trends in concentrations in the bank's five largest credit exposures and deposits;
  - Trends in contingent liabilities; and
  - Trends in the bank's liquidity profile.
- Information of the bank's impaired/non-performing assets and provisioning.
- Details of any significant issues identified at the last visit, e.g., changes in credit systems, delegations, responsibility of the bank for monitoring exposures and reporting to Head Office.

- Subsidiary banks and branches of foreign banks are likely to be subject to an annual review/audit by Head Office which will focus on a number of areas including asset

[3] The letter to the bank confirming arrangements for the on-site visit should also include an outline of topics for presentation/discussion at the opening meeting by the bank's senior management.

quality. Accordingly, it is important that copies of these reports be obtained, reviewed and issues discussed with local management, as appropriate.

- Details of areas identified by off-site analysis of data and other information that has a bearing on the on-site visit.

4.2 Preparation of Letter to Bank Confirming On-site Inspection

The letter to the bank setting out the arrangements for the on-site visit should detail:

- The dates of the visit, and the starting time on the first morning;
- The names and titles of supervisory staff attending;
- An outline of the topics for presentation/discussion at the opening meeting;
- A brief outline of the purpose of the visit; and
- Requests for additional information.

Depending on the purpose of the visit, e.g., credit, liquidity, operational risk or AML, the bank should be asked to give a presentation outlining its risk management systems at the opening meeting. Where there are particular areas of interest, these should also be noted for discussion. (Samples of letters for visits are included in attachment A4.1 & A4.2).

Typically it will be necessary to request additional information from the bank prior to the visit. When preparing the list of additional information to be provided, it is often useful to discuss aspects of the bank's systems with the bank concerned at an operational level. This provides an opportunity to clarify any areas that may be unclear from the systems description, gives the bank early warning of the types of information required, and is useful in determining the best means by which to obtain the necessary information prior to the visit. Wherever possible, use should be made of the bank's internal management reports when requesting information, e.g., if the bank produces a listing of its largest 20 problem loans on a quarterly basis for internal purposes, then the supervisor should request a copy of this report (provided it contains all the information required) rather than require that a listing be produced specifically for the visit. This also will assist with ensuring the accuracy of data provided.

4.2.1 Credit Inspections

In the case of a **credit inspection,** lists of three broad categories of loans will usually need to be requested prior to the visit:

- **Problem loans**.
- **Large exposures** – the list of large exposures will generally involve the 20 or so largest exposures.
- **Smaller performing loans** – banks should be asked to select a number of smaller, performing loans not captured in either of the above lists. The only requirement is that the selection should cover a wide range of the bank's portfolio, and not be concentrated within loan grades, industries, or at the higher quality end of the book.

Depending on the scope of the visit and the nature of the bank's operations, additional information may be requested on retail exposures (e.g., the bank could be asked to provide a selection of housing loans, asset purchase loans, etc.).

It is useful if each list contains information such client name, balance outstanding, loan grading, provisions and write-offs, security and industry of the client.

A typical 3-day visit with 4 people will enable around 35 commercial loan files to be reviewed (slightly more if personal lending files are covered). Generally, this will be a mix of problem loans (10 – 15), large exposures (8 – 12) and smaller performing exposures (12 – 20). The mix may of course be altered if there are particular areas of interest within an individual bank. However, it is important that the information requested from the bank allow for a wide sample across the bank's portfolio.

Recent reports from the credit review and/or internal audit areas of the bank provide useful information for on-site work. For foreign banks, head office inspection reports may also be available. Often such reports provide insights into weaknesses within a bank's systems and highlight areas that can be explored during the course of the visit especially to ascertain if the problem has been rectified.

It is also useful to receive a listing of the credit related reports produced for senior management and the Board. These can be reviewed in more detail during the visit.

When the material has arrived from the bank, it is necessary to select a number of files to be examined over the course of the visit. Ideally these should be advised to the bank about one week before the visit, but this depends on how quickly the material is received from the bank. **The selection of loan files to be examined should cover a broad range of the bank's portfolio.**

4.2.2 AML Inspections

AML inspections to a large extent follow the model of the credit inspection. The significant difference is that the selection of accounts and transactions to be reviewed is done on-site. This reflects concerns that banks have about allowing sensitive customer identification information out of their control. However, it also has the advantage of allowing the supervisor to choose files without the bank having the opportunity to ensure they are complete in terms of customer identification requirements etc., prior to the commencement of the visit.

Prior to the inspection, analysts should obtain the following information from banks:

- a copy of the bank's 'Know Your Customer (KYC) Policy' and any other policies relevant to anti-money laundering.
- a copy of documentation/information to be completed for account opening purposes for all customer types (e.g., Customer Acceptance Policies);
- if appropriate, policies and procedures to ensure that introduced business is consistent with the bank's own requirements (if not included in the AML policy);
- a copy of the most recent report (internal and external) on compliance with money laundering policies;
- a copy of the staff training material.

When material is received from the bank, the analyst should review the policy documents against the *On-site Inspection Manual* (see Attachment 5) to identify areas that require further clarification and discussion with the bank.

4.2.3 AML Manual

A manual to assist with conducting AML visits has been prepared (see Attachment 5). The manual outlines a work program and includes examination procedures applicable to most situations that bank supervisors encounter during an on-site inspection. It is designed to lead an examiner through the compliance review; therefore, the procedures must be followed numerically. Many procedures in the work program need to be performed only if a supervisor discovers problems or weak internal controls. Consequently, if the work program procedures are not completed in numerical order, a supervisor may need to perform more work than is necessary to adequately assess an institution's overall compliance.

Several procedures in the work program require sampling, which is either completed by the supervisor or by the institution at the direction of the supervisor. The timeframe for the sampling period varies depending on factors such as:

- The type and size of the institution;
- The number of transactions the institution typically performs in the normal course of business;
- Whether there have been any previous compliance problems or problems are suspected;
- The strength of the internal controls and audit function; and
- Whether the institution has branches or associates in an area known for money laundering activities.

The sample should be large enough that the examiner can adequately answer the work program procedure. For example, in a large institution that handles a considerable number of transactions, a short sample time frame that includes numerous transactions may be sufficient to answer the work program procedure. In a smaller bank, a longer period may be necessary to find a sufficient number of transactions to sample.

4.2.4 Operational risk inspections

The Basel Committee on Banking Supervision defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events." The definition includes legal risk but excludes strategic and reputational risk.

In February 2003 the Basel Committee of Banking Supervisors released a paper *Sound Practices for the Management and Supervision of Operational Risk*. The paper outlines a set of principles that provides a framework for the effective management and supervision of operational risk, for use by banks and supervisory agencies when evaluating operational risk management policies and practices.

The paper has 10 main principles and principles 8 and 9 relate to the role of the supervisor:

> **Principle 8**: Banking supervisors should require that all banks, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management. Supervisors should require banks to develop operational risk management frameworks that are commensurate with their size, complexity and risk profiles.

> **Principle 9**: Supervisors should conduct, directly or indirectly, a regular independent evaluation of a bank's policies, procedures and practices related to operational risks. Supervisors should ensure that there are appropriate mechanisms in place which allow them to remain apprised of developments at banks.

On-site inspections by supervisors should include the following:

- The effectiveness of the bank's risk management processes;
- Methods for monitoring and reporting operational risk;
- Procedures for the timely resolution of events;
- Internal audit and controls;
- The quality & comprehensiveness of recovery plans; and
- How it assesses capital adequacy for operational risk.

Prior to the inspection, analysts should obtain the following information from banks:

- Copies of the most recently approved operational risk policies;
- Copies of any internal reports prepared for management/board (e.g., internal/external audit) concerning operational risk issues;
- Copies of the business continuity plan and disaster recovery plan;
- A list of all major functions outsourced, including arrangements with related entities;
- Copies of any specialist reviews conducted over the past 12 months (e.g., IT, business processes);
- Copies of or examples of any reporting, monitoring and measurement tools used in risk management (e.g., control self assessment, risk registers, loss database);
- Organizational chart (including names and titles) for those responsible for monitoring operational risk.

4.2.5 Liquidity risk inspections

Banks are particularly vulnerable to sudden and unexpected demands on them for funds. Since liquidity problems in one bank can have significant implications for other banks and for the financial system as a whole, liquidity management is pivotal to a bank's operations. Banks should have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances. **The maintenance of an assured capacity to meet promptly all obligations as they fall due is fundamental to banking**. It is the responsibility of a bank's management to ensure that its internal systems and controls are adequate to ensure that resources are available to cover potential funds outflows.

Against this background:

- The Board of directors and management of a bank should implement and maintain a liquidity management strategy that is appropriate for the operations of the bank to ensure that it has sufficient liquidity to meet its obligations as they fall due.
- The bank should adhere to its liquidity management strategy at all times and review it regularly (at least annually) to take account of changing operating circumstances.
- A bank should inform the supervisor immediately of any concerns it has about its current or future liquidity, as well as its plans to address these concerns.

Prior to the inspection, analysts should obtain the following information from banks:

- Copies of the most recently approved liquidity risk policies;
- Copies of any internal reports prepared for management/board (e.g., internal/external audit) concerning liquidity risk issues;
- A copy of the most recent report prepared for ALCO (Asset /Liability Committee) that addresses liquidity management as well as copies of other relevant reports prepared to assist the bank(s) to manage liquidity. Copies of current minutes of relevant meetings for the ALCO. A copy of a charter for ALCO (if any);
- Copies of any specialist reviews conducted over the past 12 months (e.g., liquidity management);
- Organizational chart (include names and titles) for those responsible for monitoring liquidity risk.

5. During the Inspection

On-site inspections are conducted over a relatively short period of time. It is therefore important that the visit is well structured, and that all information sources fully utilized.

5.1 Preparation

Each participant involved in a visit should ensure prior to arrival at the bank that they are adequately prepared to enable them to contribute fully to the work to be done. A successful visit can only occur if all members of the team are able to contribute fully to all aspects of on-site work – this requires participants to have some knowledge of issues such as:

- The size and nature of the bank's activities;
- Its broad organizational structure;
- Its financial position (e.g., capital ratios, growth etc); and
- Any major areas of concern or special interest.

In particular, team members should be familiar with all the material provided by the bank prior to the visit.

5.2 Opening meeting

The letter sent to the bank confirming arrangements for an on-site inspection will usually request that the inspection start with a short presentation outlining the bank's risk management systems. The purpose of the presentation is to ensure that team members have a solid understanding of the policies and procedures the bank employs. While much of the information presented may already be included in other material (e.g., systems descriptions), the opening presentation is important for filling in any gaps and clarifying any aspects that may be unclear.

As on-site inspections involve an assessment of the adequacy of risk management systems employed by the bank, it is necessary to have, at the start of the visit, a good awareness of just how those systems are intended to apply in practice. In this regard, it is useful at the opening meeting to ask to be provided with copies of the bank's policy and procedures manuals for reference during the inspection.

5.3 File Review

The bulk of the time during a credit risk or AML/CFT inspection will be spent reviewing files. **Individual files are reviewed with a view to assessing whether credit management systems and account opening and other AML policies appear to be operating in accordance with policies and procedures.** In the case of credit files, the purpose of the inspection is not to review, with the benefit of hindsight, individual lending decisions and credit assessments. Rather the files are reviewed with the intention of gaining a feel for the practical implementation of credit policies and procedures.

5.3.1 Credit Inspections

From the review of files, it is intended that the inspection team be able to form views on issues such as:

- Are approvals properly documented and appropriately approved?
- Are facilities granted within the credit parameters contained in the bank's policy documents?
- Is the credit assessment adequate for the type of business being written?
- Are facilities appropriately structured and priced?
- Does the internal review function appear to be working adequately?
- Is the loan grading system effective?
- Are valuations and provisions determined on a reasonable and timely basis?

To assist in completing this task, files should be reviewed with the assistance of the loan file review worksheet (see Attachment A6.1 & A6.2). These are not only a useful means of recording information regarding each file reviewed, but more importantly, provide guidance on the issues to look for when reviewing each file. It is important when reviewing loan files not to simply fill in the line sheets, but instead to think about each aspect of the individual exposure relative to the credit management systems for the bank. Issues that should be considered when completing a loan file review worksheet are included in Attachment 7.

In particular, instances of non-compliance with the bank's policies should be highlighted, and where these appear to be more than just isolated instances, they will be discussed with the bank at a later stage.

5.3.2 AML/CFT Inspections

During the inspection a sample of the bank's accounts and documentation supporting transactions will be reviewed. The sample should include:

- Personal accounts – local and foreign currency;
- Business accounts;
- Trust company accounts;
- Introduced business accounts; and
- Wire transfers – inward and outward payments.

In reviewing these documents, consideration should be given to issues such as:

- Does the bank have all required documentation to open the account?
- Does the bank know the beneficial owner and understand the nature of transactions being conducted through the account?

- Are unusual or large transactions subject to scrutiny?
- In the case of international companies which issue bearer shares, has the bank taken steps to secure the shares?
- Does the bank have access to information provided to it by introducers?

To assist in completing this task, files should be reviewed with the assistance of the review worksheet (see Attachment A5.1 & A5.2). This is not only a useful means of recoding information regarding each file reviewed, but also can provide guidance on the issues to look for when reviewing each file.

5.3.3 Operational risk inspections

An operational risk inspection will differ from either a credit or AML/CFT risk inspection in that you will not be reviewing files. Rather from a review of policies, internal reports and discussions with staff (management and front-line) you will better understand the bank's approach to the management of operational risk.

In discussing operational risk management the following questions are suggested as a basis for reviewing a bank's policies and procedures and improving the supervisor's understanding of the bank's processes:

- **Policies and procedures:**
    - Does the bank have an operational risk policy (apart from Group policy)?
    - What are the major operational risks faced by the bank?
    - How often is the policy reviewed? Sign-off by board/head office?
    - How does the bank manage its operational risks?
    - Scope of internal audit covering op risk?
    - Reporting lines for op risk? What reports are prepared and frequency of reporting?
    - Explain op risk and compliance functions at bank and who is responsible.
    - Any op risk training programs?
        - Training for all risk areas: Frequency? Content? Who attended? Sample?
    - Explain how the bank identifies op risk
    - What are the Key Risk Indicators (KRIs) for the bank and which ones are most effective?
    - Any loss register for errors (e.g., internal fraud, business disruption)?
    - Who conducts scenario analyses and how often are they conducted?
    - Is there a scorecard and if so how often is it completed and can we have an example?
    - Results of scorecards and risk assessments – who are these reported to?
    - Action list and follow-up – is there one and who is responsible?
    - Explain how the bank controls/mitigates op risk? Insurance coverage for the bank; who underwrites the insurance and who at the bank determines if cover is appropriate?
    - Relationship with head office? What is the level and scope of reporting? Are operational risk plans in the local branch/subsidiary subject to review by head office?

- **New products**
    - Explain the new product approval process?

    - What 'sign-offs' are required before a new product is launched. Is internal audit involved in the process?
    - Any new products in the pipeline?

- **Compliance**
    - What tools/techniques are used in compliance management?
    - What are the major compliance issues facing the bank?
    - What are the monitoring processes for regulatory and legislative change?
    - Reporting to management, board, head office? Frequency?

- **Fraud**
    - Any fraud management program documented?
    - Employee awareness training on ethical principles and fraud prevention and action? Frequency?
    - Responsibilities for investigating and reporting on fraud incidents?
    - Disciplinary procedures?
    - Loss experience – frequency and source of fraud?

- **Outsourcing**
    - What, if any, functions are outsourced arrangements?
    - How are these managed? What reports are received?
    - Does the bank have an exit strategy?
    - Does the party providing the service have a business continuity plan which is consistent with that of the bank?

- **IT Security**
    - Major IT risks facing the bank?
    - Training programs?
    - How often are access controls reviewed and by whom?
    - Controls on products?

- **Business Continuity Planning**
    - Which are the bank's critical operations and services and what are the maximum down times tolerated?
    - Recovery strategies?
        - Does the bank have an alternate site in case the branch is closed?
        - Back-up facilities at the alternate site?
    - Data backup and recovery procedures?
    - Responsibilities of staff in the event of an outage?
    - Fire drills conducted? Testing of power generators? Back-up fuel for generators?
    - Staff awareness of BCP?
    - BCP tested? Frequency? Reporting of results?
    - Backup systems?
    - Planning for avian flu and other shocks or natural disasters?

5.3.4 Liquidity risk inspections

A liquidity risk inspection will follow a format similar to that of an operational risk inspection. The focus will be reviewing the bank's policies and procedures, internal reports and discussions with staff involved in the management of the bank's liquidity. The aim of the inspection will be to form a view as to whether or not the bank is managing its liquidity (e.g., inflows and outflows) and that it has considered what steps it would take in the event that there was a run on the bank.

In discussing liquidity risk management the following questions are suggested as a basis for reviewing a bank's policies and procedures and improving the supervisor's understanding of the bank's processes:

- **Policies and procedures**
    - How often is the policy reviewed/ Signed-off by board/head office?
    - How are limits communicated to responsible staff?
    - Mismatch limits – can you explain how they are monitored?
    - What corrective action if limits breached?
    - Concentration limits?
    - Diversification policy?
    - Reliance on head office for support?
    - Foreign currency liquidity risk – how monitored? Reporting?
- Relationship with head office? Frequency of reporting and nature of reports?
- Stress testing?
- Reconciliation?

- **Role of ALCO**
    - Frequency of meetings?
    - Who is present at the meetings?
    - Supervisors should ask for a copy of an ALCO pack?

- Monitoring compliance with statutory liquidity requirements?

- **Contingency planning**
    - Does the bank have a plan?
    - Who is responsible for maintaining the plan?
    - Are staff aware of their responsibilities?
    - What standby funding arrangements are in place with Head Office or other local banks?
    - How often is the plan reviewed?

5.4 Interviews and Discussions

It is useful during the course of an inspection to discuss various issues with a bank's staff in order to ensure that all staff, not just senior management, understand the bank's policies. This is particularly the case in relation to AML given the role of tellers and others involved in accepting cash and monetary instruments. These meetings could take a couple of forms:

- Formal interviews, in which bank personnel meet with the on-site team to discuss a particular aspect of the bank's approach to credit risk management or AML policies and procedures; or
- Informal discussions with account officers.

It is also useful to view, where possible, internal management reports and audit findings, as these provide further input into the assessment of a bank's systems.

5.5 Closing Meeting

At the conclusion of the visit, **the team should discuss their impressions of the bank and form some views on the adequacy, prudence and effectiveness of its risk management systems** before delivering the report to bank management. This is important as it will ensure that the team has understood issues and also it allows the team to identify examples to cite to the bank. *It is no good going into the closing meeting and making vague statements 'that there is a problem with …'.* M**anagement will challenge you and it is therefore important to be able to back up any statements with facts.** Again it needs to be stressed that we are only looking at a small sample so it is reasonable to assume that if the problems exist in a small sample then there could be bigger problems.

These judgments will be based on:

- Findings from file reviews;
- Information gained from discussions; and
- Comparisons with other banks.

The closing meeting is normally held with the bank's managing director and other staff. During the meeting, the supervisor will outline the impressions, observations and comments of the team's assessment of the bank's risk management systems. This provides an opportunity to raise any outstanding issues, and gives the bank the opportunity to comment on the team's views and to clarify any issues that may have been misunderstood.

The bank should also be informed of the process following the visit and that a letter will be sent to the bank formally advising it of the supervisors' observations. It is unlikely that the letter will raise any issues that were not discussed in the closing meeting. **The supervisors should advise the bank that it expects a copy of the letter to be provided to the bank's board, or in the case of a foreign bank, the bank's parent.**

6. After the Inspection

After an inspection of a bank is concluded, an assessment of the bank's risk management systems needs to be provided to the supervisor's senior management. This could occur as per the following outline below.

6.1 Verbal Report

To ensure that management is quickly alerted to any important issues that have arisen during the course of the visit, the lead inspector should provide a verbal report to the head of the department/agency. This will then be followed up in due course with formal reports of the on-site work.

6.2 Meeting Notes and Assessment of Management Systems

Analysts are responsible for the preparation of diary notes of all meetings held over the course of the inspection. In particular the diary note of the closing meeting should be prepared within two days of the meeting as **the issues discussed at this meeting form that basis of the letter to the bank.**

The analyst responsible for the supervision of the bank should prepare a report of the inspection which outlines the structure of systems, and highlights any strengths, weaknesses, inconsistencies or apparent policy breaches. **Matters identified in this note also form the**

basis of the letter to the bank and accordingly this note should be prepared shortly after the visit.

6.3 Letter to Bank

This letter provides the bank with formal advice of observations of the inspection. Wherever possible, the letter should not contain any matters that were not raised at the closing meeting, although there may be circumstances in which matters have subsequently come to light and require clarification. In drafting the letter care should be taken to avoid any favorable comment or endorsement of a bank's system – issues should be expressed as *observations* rather than praise or criticism. The bank should be invited to comment on observations made and, **where remedial or other action is required to be taken, the supervisor should set a date by which time the bank should respond and the analyst should ensure compliance with the requirement.**

Sample letters to banks covering both credit and AML on-site inspection are included in Attachments A4.3 and A4.4 respectively.

As with prudential consultations, these letters should be copied to the bank's board or Head Office.

CHAPTER 7 – OTHER PRUDENTIAL GUIDELINES & REQUIREMENTS

1. Overview

This chapter outlines some other prudential guidelines and requirements that have been issued by supervisory agencies and have not been specifically addresses in earlier chapters, e.g., audit arrangements, customer due diligence.

2. Prudential Guidelines

The guidelines set out policy requirements and provide guidance to banks as to the supervisor's minimum expectations. Guidelines also provide greater clarity to aspects of the supervisory regime and legislation. For example, a capital adequacy guideline contains much more information on the risk weighting of various asset items and outlines requirements relating to the composition of capital.

2.1 Audit Arrangements

Auditors play an important part in the supervisory process. A number of jurisdictions impose requirements on auditors and bank management to supply certain information to the supervisor. In addition, there are often statutory obligations imposed on auditors, e.g., a duty to report breaches of legislation or where a bank may be insolvent or acting in a manner detrimental to the interests of depositors.

2.1.1 Requirements on External Auditors

In a number of jurisdictions, external auditors are required, within 3 months of the annual balance date of a bank, to provide simultaneously to the supervisor and the bank's audit committee a report up to the latest balance date detailing the external auditor's opinions as to whether:

(a) the bank has observed all prudential standards;
(b) the statistical and financial data provided by the bank to the supervisor are reliable;
(c) the bank has complied with all statutory requirements, any conditions on the banking license, and any other conditions imposed by the supervisor in relation to the bank's operations; and
(d) there are any matters which, in the auditor's opinion, may have the potential to prejudice materially the interests of depositors of the bank.

In addition, management letters (i.e., letters from the auditor to the bank setting out issues/concerns identified during the course of the audit which typically include management's response to matters raised) relating to work undertaken by the auditor which have a bearing on the auditor's opinions should accompany the report.

In addition, supervisory agencies in a number of jurisdictions may request an external auditor to undertake a specific review, a **targeted review**, of a particular aspect of a bank's operations or risk management system. The cost of specific reviews will be borne by the bank. The review will result in a report being submitted to the supervisor which should cover the strengths and weaknesses of the risk management system in the designated area(s). When commissioning such reports, supervisors should target areas in which they do not have expertise.

2.2.2 Requirements on Management

In addition to the requirements placed on a bank's external auditor, the bank should be required to provide the supervisor with high level descriptions of its key risk management systems covering all major areas of risk. The bank should keep the supervisor informed of all material changes to its risk management systems descriptions as they are made.

As part of the arrangements with external auditors, some jurisdictions require that within 3 months of its annual balance date, a bank should provide the supervisor with a "declaration" from the chief executive, endorsed by the Board or in the case of a foreign bank branch, by a senior officer from outside the country with responsibility for overseeing the local operations.

The "declaration" should attest that, for the previous financial year:

(a) the Board and management have identified the key risks facing the bank;
(b) the Board and management have established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits, and by adequate and timely reporting processes;
(c) these risk management systems are operating effectively and are adequate with regard to the risks they are designed to control; and
(d) the risk management systems descriptions held by the supervisor are accurate and current.

If a bank feels it needs to qualify the declaration, it would need to explain the reasons for the qualifications, as well as provide plans for corrective action.

2.2.3 Statutory Obligations imposed on auditors

As mentioned above, in some jurisdictions a bank's auditors are required to inform the supervisor if they have reasonable grounds for believing that:

(a) the bank is insolvent, or is likely to become insolvent; or
(b) the bank is likely to be unable to meet its obligations or is in serious financial difficulties; or
(c) a criminal offence involving fraud or dishonestly has been committed; or
(d) serious irregularities have occurred, including irregularities that jeopardize the interests of depositors and creditors of the bank; or
(e) losses have been incurred which substantially reduce the capital funds of the bank; or
(f) the bank has failed to comply with a directive or guideline issued by the supervisor.

The failure by an auditor to comply with the statutory requirements imposed under both Acts can result in the auditor's being fined.

2.2.4 Statutory Obligations imposed on banks

As a general rule, the appointment of an auditor must only be made subject to the prior approval of the supervisory authority being obtained. In approving the appointment the supervisor must give consideration to the experience of the auditor and that the auditor is a 'fit and proper' person, i.e., in addition to fitness and propriety considerations the auditor should have experience in auditing banks.

Legislation in some jurisdictions requires banks to provide the supervisor with notice in writing if they intend to **terminate** the appointment of their external auditor. If such notice is received, the supervisor should meet with the bank to clarify reasons for the termination. It may also be appropriate to meet with the external auditor, as the reason for the termination could relate to the fact that the auditor had concerns about the bank or was to issue a qualified audit opinion.

2.3 Dealings with subsidiaries and associates

Typically legislation requires that banks obtain the supervisor's prior approval before establishing a subsidiary or branch overseas. The reason for this is to enable the supervisor to understand the nature of activities to be undertaken by the subsidiary and how it will be managed.

A bank must ensure that its subsidiaries and associates have sound and prudent management responsible for achieving the viability of these entities from their own capital resources, and that they do not give any impression that the bank's resources stand behind, or could be called upon to stand behind, their operations.

A bank should not give a **general guarantee** of the obligations of a subsidiary or associate. Where a foreign bank wishes to give a general guarantee to its local subsidiaries or operations, **particularly in relation to liquidity management**, the bank should be able to demonstrate that the home supervisor is aware of the obligations and has no objection to the transaction. The reason for this requirement is related to the capital adequacy framework; it is difficult, if not impossible, to determine the appropriate capital charge for what is essentially an unlimited guarantee. Banks are permitted to issue **specific guarantees** (as to time and amount).

A bank's dealing with its subsidiaries and associates should be on an arms-length basis, i.e. they should not receive any more favorable terms than would an unrelated party dealing with the bank.

2.4 Fit & proper requirements

In most legislation in the region, supervisors must approve the appointment of senior bank officers, and it is not unusual for these requirements to extend to directors and external auditors. Fit and proper requirements need to be considered on an on-going basis and not just at the time of licensing. When considering an application, a supervisor should also make enquiries of overseas regulators and agencies if the person(s) have worked overseas.

Legislation also gives the supervisor the power to direct that a bank remove a person if the supervisor finds that the person does not meet one or more of the criteria for fitness and propriety.

In the event the supervisor decides a person is no longer fit and proper or has an objection to the appointment, the supervisor should clearly set out reasons. Letters should be provided to both the bank's board and the individual concerned.

2.5 Physical presence and employees

This concept typically applies only to offshore banks.

It is important that the concepts of "mind and management" and "four eyes policy" be considered together when addressing the requirements placed on offshore banks. To be considered other than as a "shell" operation, a bank should be able to show that those present in the jurisdiction are actively involved in the day-to-day decision-making affecting the policy, strategy and conduct of the business. In order to comply with normal spread of control concepts, it would be expected that such powers were not vested in one individual alone, and this implies that a minimum of two senior persons, including the chief executive, should be resident. The precise number of staff required can only be assessed against the intended business plan, taking into account the necessary systems and controls to manage the risk. The job titles are in themselves unimportant, but they should be assessed according to the power and influence that they exert over the affairs of the institution.

It follows from the above that what is required in the form of books, records, systems and controls is whatever it takes to ensure that the business of the institution can be run effectively, efficiently and with all appropriate safeguards. Essentially, if it is licensed as a bank, it should "look and smell" like a bank, and its operations should be structured in such a fashion that the primary regulators can get continuous access to the management.

2.6 Assets in country

The legislative framework in most jurisdictions in the Pacific establishes the **priority of the bank's depositors** in the event that a bank experiences difficulties. Specifically, assets of the bank that are in country or outside the jurisdiction that are attributable to banking business carried on in the jurisdiction are to be made available to meet the bank's deposit liabilities **in the jurisdiction in priority to all other liabilities of the licensee**.

Legislation usually requires that domestic banks must hold local currency-denominated assets (excluding goodwill) in the jurisdiction of a value at least equal to the total amount of its local currency-denominated deposit liabilities in the jurisdiction. **Where such a provision exists supervisors should check asset and liability data to ensure the provision is being adhered to by the bank**.

2.7 Outsourcing

It is becoming more common for banks and other financial service providers to outsource[4] business activities to external service providers. While outsourcing may result in day-to-day managerial responsibility moving to the service provider, accountability for the business activity remains with the bank. It is important for banks to recognize that outsourcing a business activity does not transfer all of the risks associated with that activity to the service provider.

Some supervisors have released guidelines that set out best practice for managing all outsourcing arrangements, and that specifically apply to the outsourcing of material activities. Decisions to outsource functions remain with a bank's board of directors in terms of board approved guidelines. However, banks should be required to provide the supervisor with details of the outsourcing of material business activities.

[4] For the purpose of the handbook, outsourcing involves a bank entering into an agreement with another party (including a related company) to perform a business activity which currently is, or could be, undertaken by the bank itself. Examples include outsourcing IT systems management and operation, document processing, loan administration, back office administration, custody and investment management.

Typically any supervisory guideline should outline minimum expectations in terms of:

- Due diligence
- Business continuity planning
- Coverage of contractual agreements
- Reporting and monitoring arrangements.

Contracts between a bank and a service provider should enable the supervisor to request any information it considers necessary to satisfy itself as to the adequacy of the risk management policies of the service provider. The contract should also provide for the supervisor to meet directly with the service provider and to have access to records held by the service provider.

2.8 Business Continuity Planning (BCP)

The starting point in developing a BCP is to identify those business processes which are critical to ensuring an acceptable level of operations for each business unit of a bank. The likely financial loss for function/process within a bank[5], determined against the probability of a significant disruption occurring should be assessed.

The process should include:

- Assessing the likely disruption to business operations in the event of a loss of a critical business process for various specified periods of time;
- Determining whether alternative sources of information/services are available;
- Establishing the financial cost of business disruption and the probable recovery time for each critical business; and
- Identifying specific threats to the critical business processes.

A range of eventualities need to be covered in a BCP, including:

- The ability of the plan to cope with all potential threats, including denial of access to buildings, natural disasters, fire, water damage, disruption to power supply, communication failure, computer malfunction (involving, for example, failure of counterparty links, corruption of files due to hacking, viruses, and internal software/hardware problems);
- Loss of key staff;
- Destruction of property, whether by way of error, accidental damage, fraud, sabotage, legal action, and loss of historical data; and
- Personnel problems, including incompetence, lack of training, staff shortages, breaches of confidentiality, strikes, kidnapping, and blackmail/bribery.

The processes required for an effective BCP include:

- Establishing a clear procedure for dealing with any publicity associated with an adverse event (i.e. handling media, customers);
- Setting appropriate time frames for business resumption, having regard to business levels and the need to maintain customer confidence;

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[5] References to "bank" should also be taken to apply to the provident and pension funds.

- Clearly defining, and promulgating to all staff, the responsibilities and procedures for implementation of the plan;
- Providing staff training;
- Assigning responsibility for development, maintenance and testing of the plan;
- Involvement of internal audit;
- establishing appropriate off-site storage arrangements for critical data and specialist software, responsibility for back-ups and having adequate documentation; and
- If a bank relies on a third party to provide services (e.g., computers) determining the adequacy of the provider's BCP and if it is consistent with the bank's requirements.

At a **minimum**, the BCP must contain:

- The procedures to be followed in response to a material disruption to normal business operations. The procedures should enable a bank to manage the initial crisis, and recover and resume the critical business functions, resources and infrastructure outlined in the BCP within the nominal timeframe;
- Detailed procedures for restoring normal business operations. This should include the orderly entry of all business transactions and records into the relevant IT systems and the completion of all verification and reconciliation procedures;
- A list of all resources needed to run operations in the event the primary operational site is unavailable. This would include, but is not limited to, computer hardware and software, printers, faxes, telephones, standard stationery and forms. Additional resources include suitably trained staff and relevant documentation such as insurance policies and contracts;
- A communication plan for notifying key internal and external stakeholders if a bank’s BCP is invoked;
- Consideration of business continuity as part of any proposed material outsourcing agreement with a third party service provider; and
- Relevant information about a bank’s alternate site for the recovery of business and/or IT operations if this is to form part of the Bank’s BCP.

CHAPTER 8 – SUPERVISION OF PENSION OR PROVIDENT FUNDS

1. Overview

Pension funds play an important role in the Pacific in terms of both impact on a country's financial system and also in terms of social policy. Typically the funds are designed to provide for employees and their families a measure of financial support when income is affected by the onset of old age, permanent incapacity for work, or the death of a member. In the case of a number of funds, the support is in the form of a lump sum comprising the contributions paid to the fund by the member and employer, plus interest thereon. In a few limited instances, such as the Fiji National Provident Fund, members are also entitled to a pension.

Pension funds involve quite a different risk structure to those of banks or insurers. In the case of a pension fund, the primary sources of risk - credit risk, market risk and event risk - are all borne primarily by the investor, rather than by the institution. **Consequently, the primary focus of pension fund regulation should be on operational risk - managing fraud risk, ensuring good corporate governance and ensuring compliance risk management and investment policies**.

The need for supervision can be considered in the following terms:

- Safeguarding a country's system against risk;
- Protecting consumers against opportunistic behavior by suppliers of financial services;
- Enhancing the efficiency of the financial system; and
- Sometimes even achieving a range of social objectives (such as increasing home ownership or channeling resources to particular sectors of the economy or population).

While supervision cannot prevent a collapse, especially if there is fraudulent activity, a supervisory process can identify potential problems and implement remedial actions to correct problems.

2. Risks faced by funds

The main risks faced by a fund can be categorized as:

- **Shortfall risk**. The threat that net assets will be insufficient to cover future liabilities;
- **Asset risks**. Threats to the value, or availability of assets because of market factors, counterparty failure, or internal control weakness; and
- **Operational risks**. Threats to business continuity and security because of the failure of internal controls or inadequate planning for unexpected but possible events.

2.1 Risk Management Responsibilities

Reflecting fundamental governance principles, prime responsibility for the identification and mitigation of risks is the responsibility of the Board of the retirement fund through:

- **Sound governance** arrangements for which oversight responsibility rests with the Board and senior management;

- **Effective internal control systems** for which the responsibility for proper design, operation, and observance rests with management at all levels;
- **Regular monitoring** and reporting of control breaches, their causes, and remedial actions; and
- **Independent audit review**, by both internal and external auditors, on the effectiveness of control systems and the quality of financial disclosures concerning risks and financial conditions.

The supervisor should use a supervisory process that seeks to establish that: proper risk management arrangements are in place, the retirement fund is properly managed, and the fund has adequate resources to meet changes in member choice and potential shocks. This requires:

- An understanding of the key risks and associated controls;
- Regular analysis of information to identify possible changes in risk exposures; and
- Knowing the right questions to ask, and what the answers mean.

2.1.1 Outsourcing and other risk management issues

A particular risk that confronts funds is outsourcing; for example, a fund may outsource the management of its investments. It is becoming more common for financial service providers, such as pension funds, to outsource business activities to external service providers such as investment management. While outsourcing may result in day-to-day managerial responsibility moving to the service provider, accountability for the business activity remains with the pension fund. **It is the responsibility of the Board and senior management to ensure that adequate risk mitigation practices are in place for the effective oversight and management of outsourcing arrangements.** This means that:

- The Board-approved outsourcing policy should address all risks associated with outsourcing, including managing and monitoring the outsourcing arrangement, selecting a qualified service provider, structuring the outsourcing agreement (including contracts and service level agreements), and establishing appropriate business continuity plans, including exit strategies;
- There are written contractual arrangements between the fund and the investment manager which clearly specify acceptable investment assets, expected rates of return, dispute resolution procedures, breaches of investment limits, etc.;
- The Board should put in place procedures to monitor and control outsourcing risk in accordance with the approved policy. The actual reporting framework, to both the Board and senior management, should reflect the size and nature of the arrangements.
- There should be a due diligence process which should, as a minimum, assess the financial ability, technical ability and capacity of the service provider to deliver the required services. The evaluation process would include an assessment of the service provider’s control framework, covering performance standards, policies, procedures, compliance, reporting and monitoring processes.

In addition to the issues outlined above, consideration needs to be given to issues such as:

1. Qualifications for the Board, CEO and managers;
2. Corporate governance policy and procedures;
3. Business planning and strategy;

4. Internal controls, accountabilities and reporting procedures;
5. Internal audit and compliance with legislative and regulatory requirements;
6. Contributor/beneficiary records and accounts;
7. Reporting to members and general disclosures;
8. Resolution of contributor and beneficiary complaints.

3. Developing a supervisory framework

The imposition of a supervisory framework on a fund, which have largely have been unsupervised until recent years, will need to be managed by the supervisor. This will entail meeting with stakeholders to give an **overview of the background to the proposal and the objectives of prudential supervision,** i.e., the prudential focus on protecting the interests of contributors and beneficiaries akin to that applied to the regulatory supervision of deposit-taking institutions and insurers. In this regard the supervisor will also need to collect a range of data on the fund's performance, assets and liabilities, meet with the Board and Management on a regular basis and conduct on-site inspections to ensure that the fund has prudent risk management policies in place, e.g., in the area of credit risk and investment policies. In developing a legislative and supervisory framework for pension/provident funds, the following issues should be taken into consideration:

- Licensing scope and requirements for incorporated trustees;
- Minimum solvency requirements[6];
- Fit and proper criteria for board/trustees (and senior management executives);
- Board powers and responsibilities;
- Conflicts of interest and related party dealings;
- Maintenance of risk measurement and management systems;
- Asset and liability accounting and valuation bases for prudential purposes, including non-traded or thinly traded assets;
- Investments:
  - Investment objectives and strategy, particularly diversification and risk/return trade-off and responsiveness to market circumstances, and use of derivative instruments;
  - Quantitative and/or qualitative limits on asset classes, counterparty and risk; and
  - Assessment of derivative instruments - risk mitigation or trading.
- Controls over and accountability of external managers and custodians;
- Reporting obligations on custodians, investment managers and fund reconciliation;
- Calculation and disclosure of financial performance with a particular view towards transparency and comparability;
- Independent audit and certifications for regulatory purposes;
- Actuarial valuation, including liquidity forecasting and reporting requirements;
- Notification to the supervisor by auditors and actuaries in specified circumstances;
- Statutory returns and reports for prudential and statistical purposes;
- Off-site examination – compliance and prudential adequacy;
- On-site inspection and access to accounts and records; and
- Investigations, enforcement and problem resolution.

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[6] It is usual for incorporated trustees to maintain sufficient solvency (being a corporation) in its own right in order to validly sustain its operations.

3.1 A proposed supervisory approach

This section presents a framework that could be used by supervisors and the steps needed to implement the underlying supervisory practices. As noted earlier, in considering the supervision of the funds it is important to note that as a pension fund, the primary sources of risk - **credit risk**, **market risk** and **event risk** - are all borne primarily by the member, rather than by the institution. Therefore there is a significant amount of trust placed on the trustee of the fund and **in this context, TRUST is the acronymic name given to a possible supervisory framework**[7]**.**

The objective is to establish a framework that could be clearly related to what should be a fund's stated values and governance arrangements while, at the same time, incorporating the relevant major elements of risk based supervisory frameworks used in other countries.

The supervisory approach takes into account both off-site and on-site supervision of a fund. In this regard, supervision of a fund can be based on a framework similar to that used for banks, i.e. data analysis (supervisory returns, annual reports and other information), prudential consultations and on-site inspections. Consultations with a fund should be held at least annually and should be based on the model outlined for banks. Discussions should focus on performance, issues confronting the fund, issues arising from either off-site work or on-site inspections and changes to risk management systems.

3.1.1 The Main Elements of TRUST

Element	***Description***	***Supervisory Objective***
T	**T**rustee integrity and governance oversight.	To verify that the Board of Trustees is independent and has requisite experience to approve and oversee governance arrangements covering: o strategic planning, o risk management, internal control and audit systems; o investment strategy and performance; o actuarial assessment of solvency; and o transparent disclosure to members and other stakeholders. (i.e., areas covered by the Governance Statement)
R	**R**isk management.	To ensure that the Board of Trustees and management have: o a structured risk assessment process that identifies all risks and emerging challenges from both internal and external sources o placed values or limits on risks that are not acceptable; and o regularly reviewed risk experiences against expectations.

[7] This process was developed as part of International Monetary Fund (Monetary and Capital Markets Department) technical assistance to the Reserve Bank of Vanuatu and the Reserve Bank of Fiji, and draws on my experiences with APRA.

U	**U**nderlying knowledge and capacity to manage investments.	That the fund has: o developed a properly considered investment strategy which is consistent with, and is being implemented to achieve the investment objectives of the fund: o technical and operational staff who understand the nature of the strategy, financial instruments they invest, and the measures used to manage risks in terms of the strategy; and o established adequate capacity to cover the departure of one or more key investment or operational staff members.
S	**S**trength of management, and effectiveness of control systems.	That management: o meets high standards of competence, integrity, and knowledge to properly carry out its responsibilities to members; and o ensures that effective the internal control systems including internal audit are in place, and are observed, to manage or mitigate risks.
T	**T**ransparency in solvency, and strategic planning.	That processes are in place for: o regular actuarial assessment of liabilities; o addressing solvency or shortfall issues; and o providing transparent disclosure to members and other stakeholders on the financial performance and position of the fund.

3.2 How TRUST works in Practice

In practice, TRUST will involve linking the results of off-site monitoring and analysis to the specific topics and issues for on-site examination and consultation. To do this, supervisory staff will develop guidance checklists and questionnaires for reviewing information received through regular reporting, analyzing new investment proposals of the fund, and for identifying and reviewing specific areas during on-site examinations.

The checklists and questionnaires can be based, in part, on work already done including supervisory policy statements. Others such as those for investment operations and liability valuation may need to be supplemented by further technical assistance. The general approach is to develop lists that relate to each of the objectives of the five TRUST elements. The content of the checklists and questionnaires will also relate to those areas where supervisory policy statements have been issued or legislative requirements exist.

A format for a checklist relating to investment management, and which can be used for other areas, is shown in Attachment 8. **It should be noted that guidance notes and questions are only a guide and should not be followed in every instance**. The information and prompts have been designed to provide useful guidance in this area while allowing a degree of flexibility for analysts to use their judgement and/or experience as to how best to meet the above objectives.

3.2.1 Supervising investment operations

As a general policy, the supervisor should require any pension fund to have in place an overall strategic investment policy, including objectives, and asset allocation. The strategic investment policy should be clearly stated in an investment policy statement (IPS) that is approved and reviewed annually by the Board of directors. The IPS should contain the following:

- Investment policy
- Investment objectives
- Investment procedure
- The determination of strategic asset allocation, that is, the long-term asset mix over the main investment categories
- The establishment of limits for the allocation of assets by geographical areas, markets, sectors and currency
- Expected rate of return
- Benchmark selection.

A copy of the IPS should be sent to the supervisor for information purposes. Submission of the statement to the supervisor once it has been approved, or when amended, by the Board of Trustees allows supervisory staff to review the document in terms of the TRUST framework well ahead of any on site review or consultation with the fund. Then, to the extent that supervisory staff have no concerns, the list of documents or reports requested for an on-site visit becomes shorter. (In addition, the fund should send a copy of the IPS to investment managers, investment consultants, internal and external auditors and the actuary for information.)

3.2.1.1 Asset allocation

The supervisor will need to be satisfied that suitable attention is paid by the Board of Trustees to determining the suitable asset allocation. Internationally this aspect is regarded by investment managers and supervisors alike as the most important investment decision of a governing board. In formulating the asset allocation, the Board of Trustees should consider at least the following:

- The risk tolerance for the fund
- Estimated cash flow requirements
- Expected return
- Liabilities structure and amount
- Appropriate matching of assets and liabilities.

3.2.1.2 The Issue of Quantitative Regulation of Asset Allocation by Supervisors

As a general rule, the supervisor should not impose quantitative limits on asset allocation. This reflects the supervisory principle that the detailed formulation of a pension fund's investment management policy and internal risk control methodology is the responsibility of the governing board; fund asset allocation currently is set and reviewed annually by the Board of Trustees. In some countries, however, supervisory authorities apply quantitative requirements for currency matching/hedging limits. As with asset allocation decisions generally, however, currency exposure decisions should be the responsibility of the Board of

Trustees. Further, the Board of Trustees should also be the body to decide on hedging strategy.

However, in the context of changing investment policy and asset allocations, it may be necessary to consider some exceptions where quantitative regulation may be necessary, including::

- New asset classes such as private equity and project financing
- Derivatives
- Minimum diversification requirements
- Self-investment/conflict of interest.

3.2.1.2 Private Equity

Because of their illiquidity, and difficulty in obtaining reliable valuations, it may be appropriate that private equity participations should be subject to prior approval by the supervisor. As a potentially new asset class for a fund, investment staff are unlikely to have had previous experience, nor to have developed the skills to judge investment opportunities. Although potential gains are higher than traditional equities, bankruptcy rates are also typically higher and, therefore, diversification is necessary.

The same principle should apply to project finance, where there may be pressure to participate in higher risk or even low return projects. There are many examples in other countries where government pension funds have been used to finance low return projects, such as infrastructure projects, in the name of fostering economic development and growth.

3.2.1.3 Use of derivatives

Approval from the supervisor should be required before any initial operations are commenced that involve a new derivative instrument. In reviewing any proposal, the supervisor should obtain sufficient information on the fund's policies and procedures on the use of derivatives, as well as requesting information on the purpose which particular derivatives are to be used, and the rationale for undertaking particular transactions. **Approval should also not be forthcoming before appropriate internal controls and accounting procedures have been developed and tested**.

Once approved, the investment managers may use futures and options and other derivatives for effective fund management or hedging purposes. For example, when a portfolio manager wants to quickly invest large amounts of incoming cash, a part of the cash inflow may be used to purchase a stock index futures contract so that the total contract value approximates the size of the inflow to avoid sizeable commissions and price impacts. Derivatives might also be used to hedge currency risk, for example, through a foreign currency forward sale that protects the value of the foreign assets.

The use of derivatives for speculative purposes should be specifically prohibited.

3.2.1.3 Foreign equity investment

Foreign equity investment, properly managed, can be beneficial in terms of achieving diversification and increases in growth assets. However, as with all equity investments there are risks, both in terms of the price of the equity and foreign exchange rate movements that will need to be managed and understood by the fund. Prior to embarking on such an investment strategy, a fund should have in place the requisite risk management policies and procedures. As with some classes of asset, the fund may chose to outsource such investments to an external manager.

3.2.1.4 Outsourcing

The supervisor needs to verify that the fund has proper systems in place for the selection and monitoring of external managers. The supervisor should also expect to find that the fund requires the same oversight and clear accountability for all outsourced functions as if these functions were performed internally, and subject to the normal standards of internal control.

The supervisor should also receive from the fund details on the appointments of managers and their mandates, including a copy of associated Investment Management Agreements and Investment Guidelines. The latter should be expected to specify the benchmark selection, target performance, level of tracking error, cash levels, specification of permitted securities, derivatives, and approved counterparties (credit risk). Analyzing investment guidelines allows the supervisor to evaluate the risk and return profile of a mandate and to determine whether any specific issues need to be raised at the next consultation or sooner. The Investment Management agreement should be expected also to specify the reporting requirements, fees, termination clauses, and indemnification conditions.

3.2.1.5 Disclosures on Investment Performance

The supervisor should check that assets are valued according to the current accounting rules. Internationally, investment performance is calculated on the basis of mark-to-market or fair value.

Where no ready market exists (such as private equity or property), estimates of fair value must be made at least quarterly. The methodology and assumption used for the estimate must be communicated to the supervisor. In terms of the fund monitoring of investment performance, the return for each asset class by the fund manager should be reported to the Board of Trustees at least quarterly. The performance should be compared with the relevant benchmark. In addition, attribution analysis should be provided by an investment manager or a custodian to show the relevant contribution of asset allocation and stock selection to the Fund’s investment performance. A common way to obtain the risk-adjusted return of an external manager is the Information Ratio (annual excess return over the benchmark performance/annual tracking error). The higher the Information Ratio, the better the risk-adjusted performance the manager has achieved. Most external managers provide the Information Ratio.

4. Reporting requirements

A fund should provide the following performance information to the supervisor on a quarterly basis. As with the supervision of banks these data would feed into an assessment of the fund and form the basis for discussions with the fund’s management:

- Overall investment performance
    - Methodology and assumption for valuation in case market prices are not used
    - Performance against the relevant benchmark
    - Information ratio for external managers
    - Copy of a quarterly report from the external managers for information purposes.

    - Exposure to derivatives if any.
- Financial performance (income and expenses)
    - Realized and unrealized gain/losses from foreign exchange transactions and revaluation (at market value)
    - Realized and unrealized gain/loss from investment transactions and revaluation (at market value). The supervisor should verify whether the method used for valuing the assets is appropriate, and include disclosure of derivative positions (at market value)
- Exposure concentrations (by asset class, issuer)
- Membership activity in terms of contributions, rollovers and benefit payments.

GLOSSARY

Arbitrage	Arbitrage is the process of taking advantage of the existence of different prices quoted for a currency or financial asset in different locations at the same time.
Asset & Liability management	The management and control, within set limits, of the impact of changes in the volume, mix, maturity, quality, and interest and exchange rate sensitivity of assets and liabilities of the bank.
Capital	Capital is the cornerstone of a bank's strength. The presence of substantial capital re-assures creditors and engenders confidence in a bank. The essential characteristics of capital are that it should: • represent a permanent and unrestricted commitment of funds; • be freely available to absorb losses and thereby enable a bank to keep operating whilst any problems are resolved; • not impose any unavoidable charge on the earnings of the bank; and • rank below the claims of depositors and other creditors in the event of the winding-up of a bank. Capital, for supervisory purposes, is considered in two tiers. Tier 1 (or core capital) comprises the highest quality capital elements. Tier 2 (or supplementary capital) represents other elements which do not satisfy all of the characteristics of Tier 1 capital but which contribute to the overall strength of a bank as a going concern.
Credit risk	The most significant and persistent risk faced by banks is credit risk – the risk that counterparties will be unable to meet their obligations. Most transactions give rise to counterparty risk, with the general rule being that the longer the claim on the counterparty exists, the greater the risk.
Foreign exchange contract	A commitment to buy or sell a specified amount of foreign currency at a set time and rate of exchange.
Foreign exchange risk	The exposure of the bank to the potential impact of movements in foreign exchange rates. The risk is that adverse fluctuations in exchange rates may result in a loss in Vatu to the bank. This risk continues until the bank covers the open position. The amount at risk is a function of the magnitude of potential exchange rate changes and the size and duration of the foreign currency exposure.
Forward contract	A forward contract obliges one party to buy and the other to sell a specific underlying product or financial instrument at a specific price, amount, and date in the future.
Forward foreign exchange position	The extent to which forward or future purchases and inflows of a currency exceed future sales and outflows. That is, the net foreign exchange position of the bank's future foreign exchange transactions.
Funding concentration	This occurs when a bank's liabilities contain an excessive level of exposure to an individual depositor, type of deposit instrument, market source of deposit or term to maturity.

Futures contract	A futures contract is an agreement to buy or sell a standard quantity of a specific commodity at a predetermined future delivery date and at a price agreed between the parties on an organized exchange.
General provisions	Provisions created against future, presently unidentified losses, that must be freely available to meet any losses which might subsequently materialize. General provisions for doubtful debts less any associated future income tax benefits (on a gross basis) count as part of Upper Tier 2 capital to a maximum of 1.25 per cent of total risk-weighted assets.
Hedging	A risk management technique to reduce or eliminate price, interest rate or foreign exchange risk exposures. The elimination or reduction of such exposures is accomplished by entering into transactions that create offsetting risk positions.
Interest rate risk	Interest rate risk is the exposure of a bank to the financial consequences of adverse interest rate movements. Interest rate risk arises when a bank's principal and interest cash flows (including final maturities), both on- and off-balance sheet, have mismatched repricing dates. The amount at risk is a function of the magnitude of interest rate changes and the size and maturity structure of the mismatch position.
Interest margin	The difference between interest income and interest expenses, usually expressed as a percentage of average earning assets.
Interest spread	The difference between the average yield on all interest earning assets and the average rate paid on all interest-bearing liabilities net of impaired assets.
KYC	Know Your Customer – all essential aspects of dealing with money laundering. Other terms include **KYCC** – know your customer's customer; and **KYCB** – know your customer's business.
Liquidity management	Managing assets and liabilities (on- and off-balance sheet), both as to cash flow and concentration, to ensure that cash inflows have an appropriate relationship to approaching cash outflows.
Liquidity planning	Assessing potential future liquidity needs, taking into account changes in economic, regulatory or other operating conditions and weighing alternative asset/liability management strategies to ensure that adequate cash inflows will be available to a bank to meet these needs.
Liquidity Risk	Banks are particularly vulnerable to sudden and unexpected demands on them for funds. Banks should have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances. The mismatch between the maturity of a bank's assets and liabilities is "liquidity risk".
Market risk	Market risk is a function of the exposure that arises as a consequence of movements in the market price of assets and positions that can be traded in a defined market. Market risk is increased not only by the volatility of market prices but also by any lack of liquidity in the market. If a market is illiquid a bank may not be able to close out a loss making position and thus prevent further losses in a falling market.
Mismatch position	Also referred to as an interest rate gap or an interest rate- sensitive position. In the context of interest rate risk management, the position arises when a bank's principal and interest cash flows (including final

maturities), both on- and off-balance sheet, have differing repricing dates. A negative or liability-sensitive gap occurs when interest-bearing liabilities exceed interest-earning assets for a specific maturity, that is, liabilities re-price before assets. A positive or asset-sensitive gap occurs when interest-earning assets exceed interest-bearing liabilities for a specific maturity, that is, assets re-price before liabilities.

Non-accrual loan These are non-performing loans and other interest-bearing assets, which have been placed on a cash basis for accounting and reporting purposes. Interest is no longer accrued on the books of the licensee as income unless paid by the borrower in cash. It is expected that all *"non-performing"* loans and other assets will be classified as "non-accruing". Good practice would also require that previously accrued but uncollected interest be reversed from income at the time these accounts are placed on non-performing/non-accrual status.

Operational risk Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems and from external events.

Options contract An options contract gives the purchaser of the contract the right, but not the obligation, to assume a long or short position in an underlying instrument or commodity at a predetermined exercise or strike price, at a time in the future. In return for this right the purchaser pays a premium to the seller (writer) of the option.

An option to buy is known as a **call option** and an option to sell is known as a **put option**.

There are two main types of options. An **American option** can be exercised any day from the start date to the maturity date. A **European option** may not be exercised before expiry.

In addition to these types of traded options, there are **Over The Counter (OTC)** options which can be customized according to demand and customer needs.

The following terminology is commonly referred to in connection with options:

- **At the money:** An option whose exercise price is equal to the current market value. Such an option has zero intrinsic value.
- **Out of the money:** An option whose exercise price is less favorable to the option buyer than the current market price. Such an option has zero intrinsic value.
- **In the money:** An option whose exercise price is more favorable to the option buyer than the current market price. Such an option has intrinsic value equal to the difference between the exercise price and the market price multiplied by the principal amount.

Outsourcing Outsourcing involves a bank's entering into an agreement with another party (including a related company) to perform a business activity which currently is, or could be, undertaken by the bank itself.

Examples include outsourcing IT systems management and operation, document processing, loan administration, back office administration, custody and investment management.

Restructured loans These are loans and other extensions of credit which have been refinanced, rescheduled, rolled-over, or otherwise modified, usually under more favorable terms and conditions for the borrower, because of weaknesses in the borrower's financial condition and/or ability to repay.

Return on Assets Return on assets (ROA) is the net profit as a percentage of average total assets. It is a key measure of a bank's overall operating performance. The ratio expresses net income as a percentage of average total assets and is a key indicator of how effectively a bank has used its total resources.

Return on equity Return on equity (ROE) is calculated by relating net income to average shareholder's equity. This provides a broad measure of a bank's effectiveness in employing its investors' capital.

Settlement risk Foreign exchange (FX) settlement risk is the risk of loss when a bank in a foreign exchange transaction pays the currency it sold but does not receive the currency it bought. FX settlement failures can arise from counterparty default, operational problems, market liquidity constraints, and other factors. Settlement risk exists for any traded product. For large banks, FX transactions can involve credit exposures amounting to tens of billions of dollars each day, and in some cases, exposures to a single counterparty in excess of an institution's capital.

FX settlement risk clearly has a **credit risk** dimension. If (as is usually the case under current market practices) a bank cannot make the payment of the currency it sold conditional upon its final receipt of the currency it bought, it faces the possibility of losing the full principal value of the transaction. However FX settlement risk also has an important **liquidity risk** dimension. Even temporary delays in settlement can expose a receiving bank to liquidity pressures if unsettled funds are needed to meet obligations to other parties. Such liquidity exposure can be severe if the unsettled amounts are large and alternative sources of funds must be raised at short notice in turbulent or unreceptive markets. Finally, FX settlement risk also has a wider systemic risk dimension.

As with other forms of risk, the development of counterparty settlement limits and the monitoring of exposures against these limits is a critical control function and should form the backbone of a bank's FX settlement risk management process. FX settlement risk should be managed through a formal and independent process with adequate senior management oversight and should be guided by appropriate policies, procedures and settlement exposure limits. FX settlement risk measurement systems should provide appropriate and realistic estimates of settlement exposures on a timely basis.

The Bank for International Settlements has released several papers on settlement risk which might be beneficial. The website is: www.bis.org

A famous example of settlement risk is the failure of the German **Herstatt bank**. On June 26, 1974, Herstatt had taken in all its foreign currency receipts in Europe, but had not made any of its US dollar payments when German banking regulators closed the bank down at the end of the German business day. Counterparties were left holding unsecured claims against the insolvent bank's assets. Consequently, settlement risk is sometimes called **Herstatt risk.**

Specific provisions Provisions created against identified losses, or in respect of any identified deterioration in the value of particular assets, whether individual or grouped, foreign or domestic. Such provisions are excluded from a bank's capital resources.

Tier 1 Capital Tier 1 capital includes paid-up ordinary shares, non-cumulative irredeemable preference and any non-repayable premia arising from the issue of such shares. Partly paid shares (and other capital instruments) qualify only for the value of funds actually received. General reserves and retained earnings (including measured current year earnings net of expected dividends and taxation payments), although distributable in some circumstances, generally meet the attributes of Tier 1 capital. Minority interests in subsidiaries which are consistent with other named capital instruments are eligible to be counted in the calculation of Tier 1 capital of the consolidated group.

Tier 2 Capital Tier 2 capital is divided into two segments, termed Upper and Lower Tier 2 capital. Upper Tier 2 capital includes elements that are essentially permanent in nature and have characteristics of both equity and debt. Lower Tier 2 capital consists of elements which are not permanent. Lower Tier 2 capital may be included in Tier 2 capital to a maximum, in aggregate, of 50 per cent of Tier 1 capital (net of goodwill, other intangible assets and future income tax benefits).

SOME USEFUL WEBSITES

Supervisors may find the following websites useful. In a number of cases, the institution offers a free email notification service (e.g., the Bank for International Settlements, APRA) and this will allow you to receive notification of new policy initiatives and more generally just keep up with what is going on.

Supervisors

Australia:	www.apra.gov.au
Cayman Islands:	www.cimoney.com.ky
Jersey:	www.jerseyfsc.org
UK:	www.fsa.gov.uk
USA:	www.federalreserve.gov
Canada:	www.osfi-bsif.gc.ca

International

Basel:	www.bis.org
IMF:	www.imf.org
World Bank:	www.worldbank.org
PFTAC:	www.pftac.org

Money laundering

APG:	www.apgml.org
FATF:	www.fatf-gafi.org

Other

Definitions:	www.riskglossary.com
	www.anz.com/edna/dictionary.asp

ATTACHMENT 1 – Sample map of supervisory powers

Basel requirement	Supervisory Legislation
Independence of supervisor	Section Q.
Permissible activities	Section J.
Licensing of banks	Sections X & Y outline criteria for the issue of licenses. Prudential guideline provides additional information required from applicants.
Change in ownership	Section X.
Prudential rules	Section X gives the supervisor the power to issue guidelines and directives. Section Y gives power to impose conditions on a license.
Acquisitions	Section T.
Requirements for internal controls (e.g., credit, liquidity, operational and AML/CFT)	Addressed in the licensing requirements and section Y.
Prudential reporting by banks to the supervisor	Section Z.
On-site examinations	Section A.
Corrective measures including the power to revoke a license.	Section B in addition section D allows the supervisor to impose a condition on a license. Section S gives the supervisor power to revoke a license. Section B covers appointment of an examiner and Section C provides for the Commission to apply to the Courts for the appointment of a manager.
Audits and the role of external auditors	Sections D through to H.
Restrictions on advances	Section T imposes a restriction on advances of 25% of capital. This extends to related parties – see also definitions for reporting forms.
Fit and Proper Requirements	Prudential guideline L sets out guidelines. Section R requires that applicants (shareholders and officers) be fit and proper. Section S gives the supervisor the power to remove officers if not for and proper.
Minimum capital requirements	Sections P & O and prudential guideline U.
Information sharing – home host supervisor relationships	Section W.

This attachment outlines a list of possible remedies for dealing with problem banks. It outlines a hierarchy of remedial actions, ranging from the ability to set differential prudential standards, through the power to levy administrative fines and to require specific actions affecting management, leading ultimately to the power to revoke the authorization and bring about the orderly winding-up of the institution. Of course, actions taken will need to be consistent with the provisions of banking legislation. The section also provides some guidance as to what should be expected in a bank's plans to deal with these issues.

Problem	Action by Supervisor	Suggested action by bank
Failure to submit information within required time or provision of incorrect data.	1. Raise issue with bank management, initially informally through discussions. 2. Formally raise concern(s) in letter to bank. Set deadline for submission. 3. If problem continues, write to managing director indicating the number of times the bank has failed to meet deadlines. Advise that if deadline is not met, the supervisor will impose an administrative fine or issue a directive requiring that the bank supply the information requested. In the case of a foreign owned bank, correspondence should be copied to Head Office/Home Country supervisor. 4. If problem persists, direct external auditor to review bank's systems to identify problems and implement corrective action. 5. Raise concerns with board of directors.	1. Management agrees to discuss issue with responsible staff and review adequacy of staff levels. 2. Management reviews procedures and ensures that importance of complying with requirements is understood by relevant staff. 3. Management commissions auditors to prepare procedures manual. 4. Management replaces staff.
Potential breach of	1. Discuss concerns with	1. Bank management agree

	2. Direct bank to increase capital – set deadline. 3. Stop dividend payments, and proposed share buy-backs. 4. Require bank to limit balance sheet growth, reduce asset levels or sell assets. 5. Monitor position closely.	2. Management agrees to increase capital by approaching shareholders for capital injection. 3. Management agrees to increase capital to an agreed margin above minimum requirement and to strengthen monitoring procedures to ensure, if necessary, that there is more warning before minimum levels breached. Such a plan should be specific, realistic, achievable and time bound.
Capital ratio falls below required minimum	1. Direct bank to rectify the problem. Meet with management/board to determine what steps the bank will take to rectify the situation, e.g., capital raising and how long this will take to achieve. 2. Seek assurances from major shareholders. 3. Stop dividend payments. 4. Direct bank to cease writing new business and/or to sell assets to reduce the capital needed to support the business. 5. Look to bring in a new shareholder. 6. If there is no likelihood that capital will be restored, the supervisor should appoint a manager/administrator to manage the affairs of the bank to protect depositors' interests.	The bank's contingency plan/capital management plan must address how the bank intends to inject additional capital from: 1. Existing shareholders; 2. The capital market/and or new investors (private placement); and 3. Secondary sources i.e. debentures/preference shares. Such a plan should be specific, realistic, achievable and time bound.
Declining asset quality	1. Meet with management to discuss issues and to	The plan should articulate how to:

	exposures or is the problem across a sector? 2. Conduct on-site inspection, review problem exposures, adequacy of provisions. Meet with risk management/collections staff to ensure that recovery unit is functioning. 3. Formalize remedial plan to address problem loans. 4. Require the bank to make additional provisions. This might also entail requiring the bank to raise additional capital. 5. Set targets and closely monitor progress by either on-site examinations or engaging the bank's external/internal auditors.	procedures by bank management/credit staff; and 3. Review of credit manuals & various credit committee approval levels.
Management problems	1. Meet with board/managing director to discuss concerns. Encourage the bank to voluntarily replace staff. 2. Use statutory powers to require bank to strengthen management with the appointment of suitably qualified personnel. 3. Formally inform bank that it should remove staff. (Reasons should be given to support this action as it can be challenged in Court). 4. Issue press statement advising of actions taken.	1. Recruit new staff with appropriate skills. 2. Replace staff.
Earnings problems	1. Monitor liquidity and	1. Plan must specify how to

	as negative comments could adversely impact the bank. 2. Meet with bank management/board to understand deterioration in earnings and actions being taken to address the problem. 3. Require bank to reduce or restructure unprofitable activities and to reduce operating costs. 4. Require reorganization of bank. 5. Require management to prepare a strategic plan and monitor progress. 6. Meet with board/management on a regular basis to gauge progress of restructuring.	causes of the loss e.g., excessive overheads or expensive cost of funds. 3. Plan must address the need to improve earnings.
Liquidity problems	1. Meet with management to understand the nature of the problem and how it is dealing with the problem. If there are unfounded rumors circulating in the market about the bank, it would be appropriate for the supervisor to issue a press statement. 2. Ensure that the bank has a contingency plan in place to deal with such crises. 3. Require bank to prepare detailed cash flow projections for the next 5 days of operations. 4. Require bank to sell some assets to increase cash holdings.	The plan should address the following areas: 1. Standby agreement with other banks/other financial institutions which the bank can fall back on; 2. Balance-sheet restructuring, where problem is medium/long term in nature; 3. Sale of Treasury Notes/Government bonds to raise cash; 4. Overnight drawing facility with other banks; 5. Additional sources of liquidity information should include confirmed lines of credit and loans available for sale, including types and

	assistance. 6. Seek support from shareholders. 7. Consider provision of support by Government. 8. If problems continue and bank does not appear to be able to survive consider arranging sale of the bank or appointing an administrator to manage the affairs of the bank.	alternative funding sources.
Weak internal controls (resulting in failure to submit reports, increased incidences of errors, failure to comply with other legislative requirements).	1. Discuss concern with management and internal & external auditors 2. Review risk management policies to ensure compliance and identify areas where policies can be strengthened. 3. Direct bank to improve risk management practices and if appropriate impose restrictions on a bank's activities until problems are rectified. **Where appropriate there should be a timeframe established**. 4. Discuss concerns with the Board.	1. Bank implements staff training requirements. 2. Management commission auditors to review existing controls with report made available to supervisor. 3. Management action recommendations made by auditor with follow-up to board and supervisor. 4. Management/board agrees to replace/strengthen staff in affected area.

ATTACHMENT 3 – Sample Prudential Consultation Agenda

Managing Director
ABC Bank Limited

Dear Sir or Madam:

Re: Prudential Consultation

I am writing to confirm arrangements for a prudential consultation to be held at your office on [*date & time*]. Attending from the [*supervisory authority*] will be [*names of staff*].

As a basis for discussion, we would appreciate a brief presentation from you and your colleagues on the nature of your operations, the bank's strategy/business plans, performance and likely developments over the coming years (including new product plans). Areas that we would specifically like to discuss include:

- Summary of performance for the year ended 31st December 200X (actual vs. budget) and forecasts for 200Y;
- An outline of the bank's main business activities and changes in strategy;
- Balance sheet developments including asset quality and projected loan growth for 2004;
- Update on the implementation of the new IT system;
- An outline of changes to the bank's risk management systems covering credit, market and operational risks; and
- An update of measures undertaken to date on Anti-Money Laundering (AML) matters.

Please contact [*name of staff member and telephone/email contacts*] if you have any questions regarding the prudential consultation.

Yours sincerely,

ATTACHMENT 4 – Sample Pre-visit Credit & AML On-site Inspection Letter

A4.1 Sample Credit On-site inspection letter

Mr. XXX
Managing Director

Dear Sir or Madam:

<u>On-Site Credit Visit</u>

I am writing to confirm arrangements for an on-site credit visit to your bank commencing at [*date & time*]. It is anticipated that the on-site visit will take around three to four days. The [*supervisory authority*] will be represented by [*name of staff*].

The main purpose of the visit is to improve our understanding of the bank's policies and procedures in respect of the bank's credit risk management system. At the commencement of the visit we would appreciate a presentation covering:

- the respective roles of each area of the operations involved in credit management;
- ongoing management of credit exposures;
- credit-related reporting to senior management and Head Office;
- any views on trends in the market; and
- arrangements for internal and external review/audit of the credit function

During the course of the visit we propose to hold discussions with staff of the bank's credit department and review a number of credit files. At the conclusion of the visit, we would appreciate the opportunity to clarify any issues and discuss our observations with you and your credit team.

Attached for your information is a list of material we would appreciate receiving. To aid our preparation and to minimize the amount of time required for the visit, it would be helpful to receive a range of information prior to our arrival (see attachment). We will select exposures for review from the lists provided and will advise you of our selection about one week prior to the commencement of the visit.

I would be grateful if you provide us with the information requested by close of business on [*date*]. Our address is:

Sincerely yours,

Pre-examination Information

1. An organization chart of the bank which includes the names of each person in charge of a major functional area – e.g., credit, operations, personnel, computer operations, internal audit. Please indicate the total number of staff in each functional area.

2. A copy of the credit policies and approval process currently in effect at the bank. Please include credit limits which are currently in effect. (If this is a bulky document, please do not try to photocopy it but indicate that it is available for review at the bank's premises).

3. An explanation of the bank's internal credit rating/classification system (if it has changed since the last visit). (This should be consistent with 9 below).

4. A copy of the latest report by the bank's internal credit reviewers/inspectors.

5. A copy of the bank's business plan for the current fiscal year.

6. Please provide a list of loans with amounts outstanding, on which the borrower has not paid interest and/ or principal payments from his/her own resources for 90 days or more.

7. A current list of exposures in the following categories showing client name, amount, industry/type of exposure, loan gradings, security position, and provisions/write-offs (if any):

- all problems and watch list exposures
- a list of your bank's 25 largest performing loans and 30 smaller performing commercial facilities
- a list of 30 housing loan files
- a list of 30 personal loan files
- a list of 20 asset purchase files.

8. A list of significant credit related reports (including their frequency) that are circulated to management and Head Office. During the visit we might look more closely at some of these reports.

9. Please complete table 1 attached regarding internal loan ratings/classifications. If it is not possible to provide that on 30 April 200X, choose another date in 200X.

Table 1
Internal Loan Ratings/Classifications

Rating	**Number of Accounts**		**Vatu amount ‘000’s**	
	This Year	A Year Earlier	This Year	A Year Earlier
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				
11.				
12.				
Total Loans				

N.B: Please, provide the information as at 30 April 200X and for the comparable date a year earlier.

Please indicate the dates.

A4.2 Sample Money Laundering On-site inspection Letter

Mr. XXX
Managing Director

Dear Sir or Madam

ON-SITE VISIT: ANTI-MONEY LAUNDERING

I am writing to confirm arrangements for an on-site anti-money laundering visit to your bank commencing at [*date & time*]. It is anticipated that the on-site visit will take around three to four days. The [*supervisory authority*] will be represented by [*name of staff*].

The main purpose of the visit is to improve our understanding of the bank's policies and procedures in respect of anti-money laundering. At the commencement of the visit we would appreciate a presentation covering:

- The respective roles of each area of the operation involved in anti-money laundering;
- Policies and procedures for dealing with money laundering;
- Account opening procedures for corresponding banks;
- Sales/purchase of monetary instruments;
- Account monitoring procedures;
- Staff training related to money-laundering;
- Compliance policies/procedures;
- Reporting to senior Management/Head Office; and
- Arrangements for internal and external review of anti-money laundering procedures.

During the course of the visit we propose to hold discussions with staff on anti-money laundering and operational issues. We will also spend some time reviewing a random sample of deposit accounts. This sample should include a selection on newly opened accounts and existing accounts across a broad spectrum of account holders. At the conclusion of the visit, we would appreciate the opportunity to clarify any issues that have arisen and discuss our observations with you and your staff.

To aid our preparation and to minimize the amount of time required for the visit, it would be helpful to receive a range of information prior to our arrival (see attachment). We would appreciate receiving this information by [*date*] at: [*address*].

If you have question on the proposed visit please contact [*name*].

MATERIAL TO BE PROVIDED PRIOR TO VISIT

Prior to the visit we would appreciate receiving from you:

- a copy of your bank's 'Know Your Customer Policy' (if this have been amended from those provided to us in [*date*]) and any other policies relevant to anti-money laundering.

- a copy of documentation/information to be completed for account opening purposes for all customer types (e.g., Customer Acceptance Policies);

- if appropriate, policies and procedures to ensure that introduced business is consistent with the bank's own requirements;

- a copy of the most recent report (internal and external) on compliance with money laundering policies;

- copies of staff training material.

A4.3 Sample Letter to bank after on-site credit inspection

Managing Director
XYZ Bank Limited

Dear Sir or Madam:

RBV On-site Inspection Report of XYZ Bank

I would like to express our appreciation for the ready cooperation we received from you and your colleagues during our on-site inspection of your bank from [*date*]. The visit proved very useful in providing an understanding of the bank's system for managing credit risk arising from lending activities.

The main points we would like to make are set out below:

1. Foreign Currency Loans

In relation to foreign currency loans repayable in local currency, we noted that the loan approval documentation did not take into account the impact of the movement in the exchange rate. In our view, and based on practices of other banks in [*country*], it would be prudent that the letter of offer for such loans be amended to allow the bank to request additional security and/or a reduction in the level of the outstanding loan balance, should there be adverse movements in the exchange rates, which could leave the bank exposed.

2. Staff Lending

Our review of files suggests that the bank may not have observed the requirements of the [*banking legislation*] on making unsecured loans to staff. The Act states that "a licensee and each subsidiary must not make, or permit to be outstanding, to any of its officers or employees in the jurisdiction, unsecured advances or credit facilities, the total amount of which for that officer or employee exceeds his or her salary for one year". We recommend that the bank review its lending policy to ensure compliance with the requirements of the Act.

The [*supervisory agency's*] notes mention that XYZ's current internal policy limits unsecured staff loans to 50% of salary. However, in the case of unsecured commercial exposures the bank does not apply any such limit, although staff is assessed on criteria applied to non-staff customers and that they do not receive any concessions. While the [*supervisory agency*] appreciates the impact that this may have on staff in that they will be forced to borrow from other banks, XYZ will need to ensure compliance with the Act.

3. Lending to Politically Exposed Individuals

The [*supervisory agency*] acknowledges that current management was not responsible for the approval of loans to some politically exposed persons, which in a few instances have become major problem loans for the bank and are taking considerable time to resolve.

Business relationships with individuals holding important public positions may expose the bank to significant reputation and /or legal risks. The [*supervisory agency*] recommends that the bank establish a local policy on lending to such persons in [*name of country*] with approvals from senior management and provisions allowing for hindsight approvals from the Head of Credit irrespective of delegations. An appropriate definition of a politically exposed person could be the one used by the bank for AML purposes.

4. Security Valuation

We note from a number of files the lack of a current valuation done on the bank's securities holdings. In another case, we noted the bank's difficulty in identifying the existence of a number of securities that were held against the client's exposure during an on-site visit to the client's property.

Security cover is an important component of good lending practice and it is recommended that the bank take steps to ensure that security valuations are up-to-date and that evidence of recent valuations is retained in lending files.

5. Approval Framework

As discussed during our review we noted a case where a major consideration that was taken into account in the assessment of a loan application was the concern that the business would be lost to either another bank or a non-bank financier. While we appreciate the competitive nature of the market, our concern is that lending decisions should not be compromised by competitive pressures as this could impact the bank's asset quality.

In making this comment, the [*supervisory agency*] acknowledges points made by management that the main focus of the bank is to write business and that there are policies in place to ensure that asset underwriting standards are maintained. However, the [*supervisory agency*] is concerned that, despite the various reports and controls in place, such a sales decision would override credit decisions especially where sales staff hold lending authority. In this regard, we accept that the structure in the jurisdiction is consistent with group policies; however, it is different to arrangements in other banks where the sales and approvals functions are clearly separated.

As discussed, the [*supervisory agency*] did not come across any indication that decisions are being made incorrectly and the [*supervisory agency*] comments are made against the background that are believed to be best practices and of a deterioration in asset quality as shown in aggregate data reported in the [*supervisory agency's*] financial sector statistics.

6. Other Branch Loans

From discussions held with the bank we understand that all loan applications from [*other branches*] must be forwarded to the bank for approval before draw-down. In our review of the files we found an instance that suggests that the loan approval procedure has not been followed through. In particular, we found "letter-of-offer" to a client in [*name of branch*] by the XYZ branch manager authorizing the loan without prior approval from the Head of Credit.

It is recommended that consideration be given to strengthening arrangements to ensure ongoing compliance with the loan approval process.

7. <u>Related Exposures</u>

In the case of related party exposures, particularly where guarantees are involved, we suggest that the bank ensure it assesses the impact of exercising the guarantee in cases where it has provided finance to all parties involved. We note your comments that the Head of Credit had also identified this as an area of concern and has been conducting training workshops to focus on the need to ensure proper assessment of the guarantor.

8. <u>Others Matter</u>

During the visit we were advised of work being undertaken to date to enhance the bank's loan monitoring system report on the balances and lending limits to the different sectors of the economy, thereby allowing the bank to develop its asset writing strategy. The [*supervisory agency*] views this initiative as a positive step forward that will aid the bank in assessing its concentrations to the different sectors of the economy.

For your records, we attach a list of credit files reviewed during the visit.

We would appreciate that the bank forwards a copy of this report to its Head Office.

Yours sincerely,

A4.4 Sample Letter to bank after on-site AML inspection

Managing Director
XYZ Bank Limited

Dear Sir or Madam:

Anti-Money Laundering Inspection Report

I am writing to inform you of our main observations and recommendations. I would like to express our appreciation for the ready cooperation we received from you and your colleagues. Overall, the visit is useful in providing an understanding of the bank's AML procedures and the general overview of the bank's AML policy.

As discussed, the main purpose of the visit was not to review files with the view to identify instances of money laundering. Rather, the purpose of the visit was to review policies to understand how XYZ Bank deals with AML. Also we assess the policy against the requirements of [*legislation, guideline*]. Against this background we have identified a number of areas, outlined below, where we believe the bank needs to strengthen its policy.

We understand that your bank's AML policies and guidelines are being updated and we recommend that the revised document bring together all relevant aspects of AML practices followed by the bank together with statutory and regulatory requirements. We would also recommend that the bank ensure that local currency-denominated transactions and accounts are monitored with the same degree of rigor as are foreign currency transactions and accounts.

The following are the main observations arising from the visit.

1. AML Policy

a) There was confusion in relation to exemptions from screening requirements granted to customers. During the course of our visit we became aware of a number of exemptions approved in April 200X. We were informed that in practice such exemptions were not used and that these exemptions would be revoked as all foreign currency transactions are subject to review. However, in discussion with other staff it became apparent that there is an informal practice of granting exceptions. We are advised that these arrangements would be reviewed and formalized if considered appropriate. We recommend that if the bank decides to exempt customers from screening requirements that it maintain a list of such customers and review the list on a regular basis. In addition, the bank will need to ensure that, in granting such exemptions, it can also comply with the requirements of [*legislation*].

b) In our view the policy document could be enhanced by including references to the [*legislation*] and in particular the penalty provisions of the [*legislation*].

c) Under the [*legislation*], all STRs are to be reported to the Financial Intelligence Unit [FIU], not the [*supervisor*] as currently stated in the bank's policy.

d) There is no provision in the AML policy on the treatment of correspondent banks and introduced customers. Some confusion exists between the view of the Managing Director and what happens (e.g., for introduced customers). There is need for this area to be spelled out clearly in the policy. In relation to correspondent banks, we understand that your head office reviews/approves the opening of such accounts. This arrangement should be incorporated in the local policy.

e) As required under [*legislation, guideline*], the customer acceptance policy must spell out clearly the type of customers that the bank does not want to deal with (i.e. politically exposed persons, etc,). At present the policy only lists those countries that are on the watch list.

f) We noted instances where ex-Bank customers were "accepted" without being subjected to AML account opening requirements. We note management's response that steps have now been put in place to get all these files in order. More generally, we would encourage the bank to update information on those clients that established accounts with the bank prior to the introduction of the enhanced AML requirements in [*jurisdiction*]. We appreciate that this would lead to a risk-based exercise in dealing with these customers.

2. Compliance Officer

a) We understand that at present, compliance officers review around 5 files per day with the main focus on ensuring that account opening procedures are complied with. While this forms an important aspect of AML requirements, we also recommend that monitoring should be extended to include a review of transactions to ensure these are consistent with information given when the account was opened. This is an important aspect of "know your customer" policy and the role of compliance, as outlined in [*legislation, guideline*].

b) More generally it would be useful if the compliance section maintain reports on STRs received and "rejected" to assist in focusing training. We were also informed that the compliance officers prepare reports in relation to the reviews of accounts that they undertake, and these reports form part of the reporting process to senior management. As previously requested, we would appreciate being provided with copies of such reports to enable us to gauge the extent of work undertaken by the compliance office.

c) In addition the bank's policy specifies that a number of AML reports are to be prepared. We would appreciate being provided with a copy of these reports.

3. Reporting

a) We were told that the managing director is provided with a number of internal compliance reports on AML issues to enable him to complete his risk management compliance reports. However as noted above, we have yet to be furnished with copies of such reports.

4. Customer Identification

   a) One of the important components of customer identification is the ability to carry out physical checks to verify the existence of a customer's business. From our review of the files and discussions held, it would appear that the bank does not do this, particularly in respect of foreign companies. We were informed that the bank takes comfort from the fact that [*jurisdiction*] is small and everyone generally knows what's happening in town. However, as you would appreciate this is not satisfactory in relation to meeting your AML requirements.

      On-going account monitoring is recommended as outlined in [*legislation, guideline*]. The bank needs to carry out visits on, say, an annual basis to verify the existence of the business of each customer. For foreign companies wishing to open accounts the bank will need to consider steps to ensure that the business exists and that transactions remain consistent with the company's stated business.

   b) One of the requirements of your bank's customer check list is getting a banker's opinion. We noted that where customers tick the 'No' response this does not seem to have raised any concern. We were told that consideration is being given to making the banker's opinion a mandatory requirement, a move which we would recommend.

   c) Review of the constitutions of international companies which have accounts revealed that they provide for the issuance of bearer shares. As suggested in [*legislation, guideline*], we recommend that the bank put in place arrangements to ensure immobilization of such shares.

5. Account monitoring

   a) As outlined in [*legislation, guideline*], on-going monitoring is an essential aspect of effective KYC procedures. A computer reporting system needs to be put in place to enable the on- going monitoring of transactions. At the moment this is done on a manual basis for all transactions. Establishing a central monitoring system will provide a more efficient means of monitoring account activities. While tellers' worksheets are reviewed at the end of the day there is no mechanism that would allow the bank to identify a series of transactions made just below the reporting 'thresholds'. We understand that consideration is being given to improving systems to allow monitoring by transaction size, etc., and we encourage such an initiative. We would appreciate being advised of developments.

   b) It was noted that the bank has mechanisms in place to review foreign currency accounts activities (i.e., transactions above [*a threshold*] are reported); however, the same level of due diligence is not applied to local currency accounts. In our view, the same level of due diligence should also be applied to the local currency accounts.

   c) It was evident from a number of files reviewed that verification of the source of funds does not take place. To assist in the on-going monitoring of accounts banks should, as outlined in [*legislation, guideline*], be aware of the source of funds. This is not only required for large transactions but for any transactions that appear to be suspicious in nature.

d) We were told that the bank only conducts checks when a significant transaction occurs. However, we understand that, in many circumstances where the officer in charge knows a customer, the background checks and the confirmation of the source of funds requirement are waived. This could potentially lead to breaches of the [*legislation, guideline*].

e) In some instances where transactions patterns differed from those originally advised to the bank, clients were asked to send in a revised account opening form. In our view, this does not address the issues of understanding the source of funds or change in activity. The bank should not process transactions unless the customer's background and the source of funds are fully made known to the bank.

g) Whilst we have been told that a list of "named persons" exists in the bank, our discussions with a number of people revealed that the list is not readily accessible. In our view, the "named person" database should be accessible to all officers who are directly involved with AML matters.

6. <u>Training required</u>

a) AML training needs to be coordinated better. This is evident from the fact that one department developed its own training documents. Although the compliance office was aware of this, it would have been useful if it had been reviewed by the compliance office to ensure that it is consistent with the bank's policies and regulatory & statutory requirements. In our opinion, the compliance department should contribute to the development of AML training documents in the future.

b) Training programs should be on a regular basis. Under the current policy, a period of three years is stated. In our view this is too long and training should occur at more regular intervals (say 6 months) especially for those staff in high risk areas, e.g., tellers and those involved in the sale and purchase of monetary instruments.

c) We understand that much of the bank's AML training is carried via computer updates, although this may be supplemented by ad-hoc training in some sections. In our view the introduction of new policies should be supplemented by formal face-to-face training.

d) We suggest that the current training document should also address the AML requirements set out in [*legislation, guideline*].

e) The training document is not dated although from discussion held, it was confirmed that the material was last presented in 200X. For continuity purposes, this document needs to be dated and updated to reflect changing policies and procedures.

For your records, attached is a list of the customer files reviewed during the visit.

Yours sincerely,

ATTACHMENT 5 – AML On-site Inspection Manual

ON-SITE INSPECTION MANUAL
CUSTOMER DUE DILIGENCE

Introduction

This manual serves as a guide for the examination of compliance with [*legislation, guideline*], and other related rules and regulations. In addition to ensuring that the institution is in compliance with applicable laws, rules and regulations, a bank supervisor should be cognizant of any unusual or suspicious activities. Activities of this nature, such as illegal acts or transactions conducted by employees or customers, may be an indication of general noncompliance in the institution.

The work program includes examination procedures applicable to most situations that bank supervisors encounter during an on-site inspection. It is designed to lead an examiner through the compliance review; therefore, the procedures must be followed numerically. Many procedures in the work program need to be performed only if a supervisor discovers problems or weak internal controls. Consequently, if the work program procedures are not completed in numerical order, a supervisor may need to perform more work than is necessary to adequately assess an institution's overall compliance.

Several procedures in the work program require sampling, which is either completed by the supervisor or by the institution at the direction of the supervisor. The timeframe for the sampling period varies depending on factors such as:

- The type and size of the institution;
- The number of transactions the institution typically performs in the normal course of business;
- Whether there have been any previous compliance problems or problems are suspected;
- The strength of the internal controls and audit function; and
- Whether the institution has branches or associates in an area known for money laundering activities.

The sample should be large enough that the examiner can adequately answer the work program procedure. For example, in a large institution that handles a considerable number of transactions, a short sample time frame that includes numerous transactions may be sufficient to answer the work program procedure. In a smaller bank, a longer period may be necessary to find a sufficient number of transactions to sample. The supervisor should document in the work papers the sampling time frame along with how it was determined.

In the column on the right hand side of the work program, provide a "yes", "no", or "not applicable" response. Some instances may require you to provide a "not reviewed" response. Additional space is also available in the column to provide comments. Comments are typically required to provide additional information about the deficiency when a "no" response is provided. Providing a "no" answer in the column does not necessarily signify that a there has been a breach of requirements. However, numerous "no" responses may be indicative of internal control weaknesses or other problems that may evidence noncompliance with other requirements.

EXAMINATION WORK PROGRAM

1. Off-site examination planning

The purpose of this section is to determine if the subject institution exhibits a risk profile suggestive of:

- Non-compliance with aspects of the [*legislation, guidelines*] and other regulations or directives issued by either the [*supervisory authority*] or the Financial Intelligence Unit;
- Ineffective internal compliance procedures; or,
- Engaging in possible money laundering activities.

	Yes	No	Comments
1) Do the findings of the previous examination report indicate a general compliance with requirements? If not, briefly identify the deficiencies.			
2) If violations or serious deficiencies were noted, does correspondence indicate that corrective action was taken? If, because of previously noted deficiencies, the institution was required to perform analyses of: (a) reporting of large transactions; or, (b) sales of monetary instruments, were such analyses performed and documented? You should review such documentation.			
3) Has the Financial Intelligence Unit (FIU) indicated concerns about the institution and has it reported that there has been any significant change in the total volume of suspicious transactions reports (STRs) submitted by the institution?			

2. Internal Compliance Programs and Procedures

[*Legislation, guideline*] requires that an institution must establish and maintain internal procedures in relation to money laundering.

Guidance Note # 1

You should be aware that even if an institution maintains in books and documents what appears to be a viable compliance program, the institution may possibly not follow the internal compliance program. Specific breaches of requirements, as discovered during the course of this compliance review, may evidence a lack, or the complete omission, of adequate internal compliance procedures.

Guidance Note # 2

The sophistication and comprehensiveness of the institution's internal compliance program should be gauged by the type of activities engaged in by the institution and the quantity of transactions. As an example, a 'wholesale' institution that conducts no cash transactions needs only to have an internal compliance program that ensures that, should a transaction that is required to be reported be presented to the institution, the institution's employees will have sufficient education to understand that the transaction may be subject to the [legislation]. For an institution that conducts a retail operation it should have specific and comprehensive internal compliance procedures. It is your responsibility to determine the appropriateness of the internal compliance program based on the institution's activities.

	Yes	**No**	**Comments**
4) As of the previous examination, had the institution established adequate internal compliance programs and procedures as required? If not, list the deficiencies.			
5) Has the institution developed a written compliance program as required under the laws and regulations?			
6) If applicable, does the written compliance program provide for the following: a) A system of internal controls to ensure on going compliance. b) Independent testing for compliance by either bank personnel or an outside party. List person(s) designated to conduct independent testing. c) Designation of a qualified individual(s) responsible for coordination and day-to-day compliance. List individual(s) responsible for compliance and appropriateness of qualifications (e.g., training experience). d) Training for appropriate personnel.			
7) Was the compliance program approved by the institution's board of directors and approval noted in the minutes? If a foreign institution, was the compliance program approved at the highest level			

of local management as well as by the home office board of directors?			
8) Does the institution's compliance program include written procedural guidelines for meeting the reporting and record-keeping requirements of the [*legislation, guideline*] and other guidelines and provide for the following, as applicable? a) The filing of a report of each deposit, withdrawal, exchange of currency or other payment or transfer, by, through or to the financial institution, which involves a suspicious transaction? b) The maintenance of required records for transactions in excess of [*threshold*], with supporting documentation.			
9) Do the procedural guidelines include provisions for the retention of either the original, microfilm, copy or other reproduction of the items listed below, and is each item retained for a period of at least [*number of years as specified by legislation*]: a) Identification documentation related to account opening. b) Records of all correspondence between the institution and the customer. c) Identification documentation required under [*legislation*] for transactions in excess of [*threshold*]. d) Details of transactions including, but not limited to: • The nature of the transaction; • The amount of the transaction and the currency in which it was denominated; • The date on which the transaction was conducted; • The parties to the transaction.			

Internal audit/Independent Review

[*Legislation, guideline*] requires that financial institutions provide for independent testing for compliance to be conducted by bank personnel or an outside party.

	Yes	No	Comments
10) Review the institution's written internal audit/independent review procedures and determine that the internal audit function provides for compliance with the [*Legislation, guideline*]. If the institution does not have an internal audit function, determine that a program of management reviews or self audits has been established which includes the requirements of the [*Legislation, guideline*]. Do audit procedures/independent reviews: a) Confirm the integrity and accuracy of the systems for the reporting of large currency transactions? b) Include a review of tellers' work? c) Confirm the integrity and accuracy of the institution's record keeping activities? d) Include steps necessary to ascertaining that the institution is conducting an on-going training program?			
11) If violations or serious deficiencies from the previous examination, has your review determined that corrective action has been taken?			

Guidance Note # 3

Evidence of violations of, or noncompliance with, specific provisions of the [*Legislation, guideline*] *may be indicative of a systemic failure of the internal audit program. As you complete the following examination procedures, you must determine whether the apparent violations were caused by misinterpretations, oversight, or technical matters rather than by an inadequate compliance program. If you feel the institution's compliance program is inadequate you may want to enhance your review (i.e. use a larger sample of transactions).*

Education

[*Legislation, guideline*] requires that financial institutions provide training for appropriate personnel.

	Yes	No	Comments
12) Review the institution's program for educating appropriate personnel regarding the [*Legislation, guideline*] and anti-money laundering to determine if the program includes the following: a) Reporting of large transactions. b) Identifying and reporting of suspicious activity or alleged criminal conduct. c) Record retention requirements. d) Sale of monetary instruments.			
13) Review the scope and frequency of training meetings to determine what importance management places in ongoing education and training. In reviewing the institution's procedures, determine the: a) Appropriateness of the scope and frequency. b) Level of compliance.			
14) Question the compliance officer and other operations personnel (i.e. tellers, branch managers) to determine whether they are sufficiently knowledgeable concerning the [*Legislation, guideline*] and other requirements to ensure compliance. (List the personnel interviewed and document their level of knowledge and how they obtained this knowledge).			
15) Interview personnel from other areas of the institution which deal in currency such as trust, loan and international departments, private banking units to determine that they are knowledgeable regarding the [*Legislation, guideline*], possible money laundering schemes, and the identification of suspicious or unusual transactions. (List the personnel interviewed and document their level of knowledge and how they obtained this knowledge).			
16) If there were violations or serious deficiencies from the previous examination, has your review determined that corrective action has been taken?			

Know Your Customer Policy (KYC)

Guidance Note # 4

The requirement that an institution have a KYC policy is an essential requirement of [*Legislation, guideline*]. *Certain key elements should be included by banks in the design of KYC programs. Such essential elements should start from the banks' risk management and control procedures and should include (1) customer acceptance policy, (2) customer identification, (3) on-going monitoring of high risk accounts and (4) risk management. Banks should not only establish the identity of their customers, but should also monitor account activity to determine those transactions that do not conform with the normal or expected transactions for that customer or type of account.*

	Yes	**No**	**Comments**
17) Does the bank have policies and procedures that require that "reasonable efforts" be made to ascertain the true identity of individual customers and/or the stated business purpose of each commercial enterprise with whom the bank conducts business?			
18) Does the institution's KYC policy include the following when opening an account: *Personal accounts* a) Procurement of proper identification (e.g., driver's license with photograph, valid passport, etc)? b) Consideration of the customer's residence or place of business? c) Consideration of the source of funds used to open the account? d) Other background checks (e.g., police, bank reference)? *Business accounts* e) Verification of the legal status of the business (i.e. sole proprietorship, partnership)? f) Verification of name of business, if applicable with a reporting agency? g) Verification that the business exists and is conducting the stated business? h) For foreign business accounts, is there proof that the business is registered in the country of origin (e.g., articles of incorporation, etc.)? i) Procurement of the following information for large commercial accounts: i) Financial statement? ii) Description of the customer's principal line of business? iii) Description of business operations, i.e.,			

retail vs. wholesale? *Trust, nominee and fiduciary accounts* j) Verification of the nature and purpose of the trust. k) Verification of the customer, i.e., whether the customer is taking the name of another customer, acting as a "front", or acting on behalf of another person as trustee, nominee or other intermediary. l) Identification of a trust should include the trustees, settlors/grantors and beneficiaries. *Corporate vehicles (e.g., international cos)* m) Verification of the structure of the company. n) Verification of the source of funds. o) Identification of the beneficial owners and those who have control over the funds. *Introduced business* p) Does the bank have policies and procedures to determine if the introducer is "fit & proper"? q) Does the bank conduct reviews of the introducer's due diligence processes? r) Do arrangements between the bank and the introducer enable the bank to verify the due diligence undertaken by the introducer? s) Is the bank furnished with all necessary documentation pertaining to the customer's identity? *Client accounts opened by professional intermediaries (PI)* t) Has the bank established and verified that the PI has established KYC procedures? u) Has the bank verified that the PI has the systems and controls to allocate assets/funds in the account to the relevant beneficiaries? v) Is the bank furnished with all necessary documentation pertaining to the customer's identity? *Politically exposed persons (PEPs)* w) Does the bank gather sufficient information on clients to establish whether or not the client is a PEP? x) Are decisions to open accounts for PEPs taken at a senior level of management? *Non face-to-face customers*			

y) Does the bank apply similar customer identification processes for non face-to-face customers as it does for those who present for interview? z) Does the bank seek to obtain certified copies (e.g., by public notary) to verify the customer's identity? aa) Does the bank attempt to make independent contact with the customer? *Correspondent banking* bb) Does the bank conduct due diligence on the correspondent bank and seek information on issues such as: i) Bank management. ii) Business activities. iii) Reason for establishing the account. iv) Identity of third parties that will use the account. v) Details of country of incorporation and its money laundering arrangements. vi) Information on supervisory arrangements in the respondent's country. vii) Confirmation that the bank is subject to adequate supervision. cc) Does the bank seek to understand the respondent's KYC policy? dd) Does the bank maintain a list of countries which have been identified as "non-cooperative" in the fight against money laundering? ee) Is this list regularly reviewed? ff) Does the bank verify that it is not dealing with a "shell bank"? gg) Do the bank's policies preclude it from dealing with shell banks?			
19) Does the institution's employee education training program provide detailed instruction in the identification and reporting of "suspicious" transactions? A "no" answer may also indicate a training deficiency and should be so noted at question 12.			
20) Does the institution have adequate ongoing monitoring systems in place to identify "suspicious" transactions? This may include: (a) The establishment of 'house' limits which will enable the bank to identify large cash deposits. (b) Systems to identify if the pattern of activity in the account has changed e.g.,			

transactions are not consistent with the normal and expected transactions of the customer.			

Funds transfers

	Yes	No	Comments
21) Is there adequate separation of duties or compensating controls to ensure proper authorization for sending and receipts of transfers, correct posting to accounts and an audit trail of activities?			
22) Does the institution accept cash for funds transfers from non-customers and, if so, does the institution require identification, maintain documentation, and file "Suspicious Transaction Reports", if applicable?			
23) Does the institution send or receive fund transfers to/from financial institutions in other countries, especially countries with strict privacy and secrecy laws and, if so, are amounts, frequency, and countries of origin consistent with the nature of the business or occupation of the customer?			
24) Does the institution have procedures to monitor accounts with frequent cash deposits and subsequent wire transfers of funds to a larger institution or out of the country?			
25) For funds transfer originations, does the institution retain the following records for each originator? (This information may be with the payment order or in the institution's files if the customer has a loan or deposit account with the institution): a) Name and address of originator. b) Amount of funds transfer. c) The date of funds transfer. d) Any payment instructions. e) The identity of the beneficiary's bank. f) Either the name and address or account number of the beneficiary.			
26) Is the institution able to retrieve the information in question 25 by the name of the originator or account number?			
27) If the originator does not have a deposit account or loan with the financial institution, does the institution verify the originator's name and address and retain a record of this information?			
28) For funds transfer receipts, does the institution retain either the original or a duplicate of the payment order?			
29) If a payment order is received for a beneficiary that does not have a deposit account or loan with the			

institution, does the institution obtain and retain a record of the beneficiary's name, address and any other identification?			
30) If the institution receives funds and it cannot identify the source of the funds does the bank return the funds and if appropriate prepare a Suspicious Transactions Report?			

Purchases/Sales of Monetary Instruments

Guidance Note # 5

The purpose of this section of the work program is to ensure that institutions maintain certain information regarding sales in currency of bank cheques or drafts, money orders or traveler's cheques.

	Yes	No	Comments
31) Do the financial institution's records include the following required information for purchasers who have deposit accounts with the institution: a) The name of the purchaser. b) Date of purchase. c) The type(s) of instrument(s) purchased. d) The serial number(s) of each of the instrument(s) purchased in currency. e) Method of verification of identity.			
32) Do the financial institution's records include the following required information for purchasers who do not have deposit accounts with the institution: a) The name and address of the purchaser. b) Method of verifying the identity of the purchaser and specific identifying information (e.g., passport, driver's license with photograph, etc). c) The date of the purchase. d) The type(s) of instrument(s) purchased. e) The serial number(s) of each instrument(s) purchased. f) The dollar amount(s) of each instrument(s) purchased.			
33) Does the institution use manual or automated systems for identifying cash sales of monetary instruments?			

Guidance Note # 6

If the review of the records of purchases/sales of monetary instruments shows unusual or suspicious patterns of purchases/sales activity that might be associated with money laundering, perform work program procedures 33 to 35. If not proceed to procedure 36.

	Yes	No	Comments
34) If the institution uses manual systems, proceed to procedure 36. If the institution uses automated systems, proceed to procedure 35.			
35) If the institution relies upon automated systems for identifying such transactions, does the internal audit/independent review adequately test the accuracy and validity of the cash purchases/sales identification system and is the system comprehensive with regard to all points of purchase/sale?			
36) If the institution relies upon manual systems for identifying such transactions, do the institution's records provide an audit trail sufficiently detailed to identify the method of payment for all purchases/sales of monetary instruments? a) Does the internal audit/independent review include a test check of teller's records to determine that the required information is properly obtained and retained?			

Terrorist Activities

Guidance Note # 7

Institutions operating in [jurisdiction] are required to comply with directives and regulations in relation to dealing with terrorist entities and, from time to time, other restricted persons/entities located in [jurisdiction] or abroad.

	Yes	**No**	**Comments**
37) Does the institution have policies and procedures in place to ensure compliance with such directives and regulations?			
38) Does the institution maintain a current listing of prohibited countries, entities and individuals?			
39) Are new accounts compared to listings prior to opening?			
40) Are established accounts regularly compared with listings?			

A5.1 AML Inspection worksheet – Account opening

AML FILE REVIEW WORKSHEET

BANK: **TYPE/LOCATION OF ACCOUNT:**

REVIEWER: **DATE:**

ACCOUNT NAME/BENEFICIAL OWNER:

CURRENCY:

ACCOUNT TYPE – TICK ONE	**DO ACCOUNT RECORDS PROVIDE INFORMATION REQUIRED ENABLING ADEQUATE IDENTIFICATION OF THE ACCOUNT HOLDER?**		
	YES	**NO**	**COMMENTS**
Personal accounts			
a) Procurement of proper identification (e.g., driver's license with photograph, valid passport, etc)?			
b) Consideration of the customer's residence or place of business?			
c) Consideration of the source of funds used to open the account?			
d) Other background checks (e.g., police, bank reference)?			
Business accounts			
e) Verification of legal status of the business (i.e., sole proprietorship, partnership)?			
f) Verification of name of business, if applicable with a reporting agency?			
g) Verification that the business exists and is conducting the stated business?			
h) For foreign business accounts, is there proof that the business is registered in the country of origin (e.g., articles of incorporation, etc.)?			
i) Procurement of the following information for large commercial accounts: i) Financial statement? ii) Description of the customer's principal line of business? iii) Description of business operations, i.e., retail vs. wholesale?			
Trust, nominee and fiduciary accounts			
j) Verification of the nature and purpose of the trust.			
k) Verification of the customer, i.e., whether the customer is taking the name of another customer, acting as a "front," or acting on			

behalf of another person as trustee, nominee or other intermediary. l) Identification of a trust should include the trustees, settlors/grantors and beneficiaries. *Corporate vehicles (e.g., international cos)* m) Verification of the structure of the company. n) Verification of the source of funds. o) Identification of the beneficial owners and those who have control over the funds. *Correspondent banking* p) Does the bank conduct due diligence on the correspondent bank and seek information on issues such as: i) Bank management ii) Business activities iii) Reason for establishing the account iv) Identity of third parties that will use the account v) Details of country of incorporation and its money laundering arrangements vi) Information on supervisory arrangements in the respondent's country vii) Seek confirmation that the bank is subject to adequate supervision o) Does the bank seek to understand the respondent's KYC policy?			

A5.2 AML Inspection worksheet – Fund Transfers

AML FILE REVIEW WORKSHEET

BANK: TYPE/LOCATION OF ACCOUNT:

REVIEWER: DATE:

BENEFICIARIES NAME:
ORIGINATOR'S NAME:
AMOUNT/CURRENCY

	Yes	No	Comments
1. For funds transfer originations, does the institution retain the following records for each originator? (This information may be with the payment order or in the institution's files if the customer has a loan or deposit account with the institution): a. Name and address of originator. b. Amount of funds transfer. c. Date of funds transfer. d. Any payment instructions. e. The identity of the beneficiary's bank. f. Either the name and address or account number of the beneficiary.			
2. Is the institution able to retrieve the information in question 1 by the name of the originator or account number?			
3. If the originator does not have a deposit account or loan with the financial institution, does the institution verify the originator's name and address and retain a record of this information?			
4. For funds transfer receipts, does the institution retain either the original or a duplicate of the payment order?			
5. If a payment order is received for a beneficiary that does not have a deposit account or loan with the institution, does the institution obtain and retain a record of the beneficiary's name, address and any other identification?			
6. If the institution receives funds and it cannot identify the source of the funds does the bank return the funds and if appropriate prepare a Suspicious Transactions Report?			

ATTACHMENT 6 – Credit Visit Worksheet

A6.1 Commercial and other loans

CREDIT FILE REVIEW WORKSHEET

BANK: **TYPE/LOCATION OF EXPOSURE:**
REVIEWER: **DATE:**

NAME OF CREDIT:
(Include names of key individuals, shareholders and/or related parties)

INDUSTRY:
FACILITY DESCRIPTION:
(Amount, type, term, pricing, profitability calculation)

PURPOSE OF FACILITY:
SOURCES OF REPAYMENT:
(e.g., cashflow, sale of security)

ARREARS/ACCRUAL STATUS:
APPROVALS:
(by whom, date, within delegation)

INTERNAL REVIEW:
(Date, frequency)

NON-COMPLIANCE WITH CREDIT POLICY:
(If any)

NON-FINANCIAL ASSESSMENT (client and guarantors):

Risks and mitigants

Industry analysis

Management analysis

Evidence of client contact

Other (e.g., history/banking relationship)

FINANCIAL ASSESSMENT (client and guarantors):

Dates of financial year (full year and interim results)

Audited, Consolidated

Profit & Loss, Balance sheet analysis

Cashflow analysis

Key ratios

Sensitivity analysis

Other

SECURITY AND/OR GUARANTEES:

(valuation amount, source, date, documentation)

COVENANTS:

CREDIT RISK GRADING HISTORY:

PROBLEMS AND WORK-OUT STRATEGY:
(if any)

PROVISIONS AND WRITE-OFFS:
(amount, method of calculation)

OTHER COMMENTS:

A6.2 Housing and personal loans

HOUSING/PERSONAL FILE REVIEW WORKSHEET

BANK: **TYPE/LOCATION OF EXPOSURE:**
REVIEWER: **DATE:**

NAME OF CREDIT:

FACILITY DESCRIPTION:
(Amount, type, term, pricing, risk grade, profitability calculation)

FINANCIAL ASSESSMENT (client and guarantors):
Income statements – type, dates and verification

Debt servicing ration (include interest rate used)

Other

FINANCIAL ASSESSMENT (client and guarantors):
e.g.: client history/banking relationships, employment verified

SECURITY AND/OR GUARANTEES:
(valuation amount, source, date, documentation)

APPROVALS:
(by whom, date, within delegation)

ARREARS HISTORY:

NON-COMPLIANCE WITH CREDIT POLICY:
(If any)

ATTACHMENT 7 – Loan File Review Worksheet: Checklist of Items to Observe

ELEMENTS	ITEMS TO OBSERVE
FACILITY DESCRIPTION	Note the structure of the facility (e.g., interest only, balloon, up-front payment of fees, pre-sale requirements for development finance).
PURPOSE OF FACILITY	Is the bank aware of the purpose of the facility? (This is relevant to the bank's assessment of the sources of repayment).
SECURITY	Is there evidence that the marketability of security has been considered? Is this an acceptable security? Is the documentation of the valuation evident on file? Is the valuation timely? Is the valuation done at the bank's instructions? Is the valuation done internally or externally? Is the valuation comprehensive (e.g., full valuation), done on a market appraisal basis, or done on an update basis? Has there been much volatility in past valuation? If so, has there been close tracking by the bank? Has the bank obtained legal advice as to the legality of the security arrangements?
PRIMARY SOURCE OF REPAYMENT	Is the bank aware of how the facility will be repaid? Structuring of facilities matches timing of cash flows from source?
APPROVALS	Has the facility been approved by the appropriate authority? Is there much input from Head Office? If Head Office input is obtained, is this obtained promptly?
ARREARS/ACCRUAL STATUS	Indicate status.
INTERNAL REVIEW	Is there evidence of close oversight by the credit control function or head office (e.g., review comments expressing concern about the structure, pricing of deal or inadequacies of credit analysis)? Are the periodic internal review requirements followed and evident in the credit file? Are they working effectively (i.e. any delays, any prior reminders from loan administration/credit officer)? Is the bank tracking the repayments of the facility? Are credit quality deteriorations recognized at an early stage?

FINANCIAL ASSESSMENT	Is the assessment adequate? Are audited accounts used? Are cash flow analyses done? Is the assessment up-to-date and are financial forecasts obtained from the client analyzed? Is there verification of income (e.g., tax statements, letter from employer, pay slip)? Are sensitivity type analyses done? Are credit analyses subject to independent reviews?
GRADING HISTORY	Is the logic behind the grading decision properly documented? Where gradings are changed, is the basis for the change documented and are account officers informed of amendments? Is the grading system working effectively? Is the grading assigned consistent across all related counterparties?
PROVISIONS AND WRITE-OFFS	Are provisions made on a timely basis? Are provisioning decisions documented?
PROBLEMS AND WORK-OUT STRATEGY	Did client make losses in the previous years? Is the work-out strategy well thought out (e.g., renegotiations of credit terms, asset sales)? Is there a timetable for recovery action? Is there evidence that the bank is devoting substantial resources to recovery action?
NON-COMPLIANCE WITH LOAN POLICY	Is the facility granted within set credit parameters (e.g., is the facility an acceptable transaction, are the LVR requirements met)?
OTHER COMMENTS	Is there evidence of regular contact with client? Are excesses monitored and approved by the appropriate authority? Is there a high incidence of excesses for the client? Is there evidence of a pricing squeeze or weakening of covenant requirements? Is the information contained in the credit file consistent with that contained in the credit management information reports and the materials provided to us prior to the visit? Is the information contained in the credit file easy to follow? Are there any comments on the credit file which have a bearing on the overall management of the account? For example, critical comments by senior management or credit review staff. General observations about the account can also be made by the reviewer.

ATTACHMENT 8 – Supervisory framework pension and provident funds

The suggested supervisory framework for the pension and provident is based on the following framework:

1. **Trustee integrity** – to ensure that the fund has reporting systems that allow it to monitor decisions, compliance with the legislation and decisions taken by the manager.
2. **Risk management** – to ensure that the Board has considered a risk assessment process which identifies all risk and emerging challenges both in terms of internal decision and control process and the external environment.
3. **Underlying knowledge and capacity to manage investments** –the fund has developed a properly considered investment strategy which is consistent with, and is being implemented to, achieve the investment objective adopted for the fund.
4. **Strength of management** – that management meet high standards of competence, integrity and knowledge to properly carry out its responsibilities to members of the fund, and where appropriate, implement corporate governance initiatives such as “conflict of interest” policy.
5. **Transparency in planning** – that the fund has a strategic plan that places due focus on the long-term nature of member interests.

It should be noted that *guidance notes and questions* are a guide only and should not be followed in every instance. The information and prompts have been designed to provide useful guidance in this area while allowing a degree of flexibility for staff to use their judgement and/or experience as to how best to meet the above objective.

SUMMARY OF MODULES

These modules and objectives are provided to assist staff and are not intended to prescribe the specific review approach in all circumstances. They have been designed to provide useful guidance while allowing a degree of flexibility for review staff to use their judgement and/or experience as to how best to meet the objective(s).

A. TRUSTEESHIP

No	Objectives	TRUST ref
1.	Determine if a process exists to appoint new board members and whether the Board has appropriate standards in place for responsible officers and other relevant personnel as well as for conflicts of interest and related party transactions.	**T & S**
2.	Determine whether the Board has considered trustee indemnity insurance.	**R**
3.	Determine whether the Board exercises adequate control over fund operations including sufficiency of board meeting arrangements and delegation structure.	**T & R & S**
4.	Determine whether the Board has adequate compliance and due diligence processes.	**T**
5.	Determine whether the Board has adequate planning in place to focus on the long term nature of the member's benefits.	**Transparency**
6.	Determine if the Board minutes adequately document decisions made regarding the running of the fund.	**S**

B. INVESTMENTS

No	Objectives	TRUST ref
1.	Determine that the Board has an investment strategy, a process for the review of the strategy; and that the Board invests in accordance with the strategy.	**U**
2.	Determine whether the Board has appropriate risk management practices and that these are consistent with the fund's investment strategy (including derivative usage).	**R & U**
3.	Determine whether any in-house assets, loans granted or borrowings are in accordance with policies and that all assets are maintained at arms-length.	**T**
4.	Determine that the assets of the fund exist, and are appropriately valued and registered in the appropriate name.	**T & U**

C. SERVICE PROVIDERS

No	Objectives	TRUST ref
1.	For each service provider determine whether: • the Board has adequate due diligence procedures in place for selection of service providers; • a comprehensive written agreement exists; • the Board retains the responsibility for delegated tasks; and the Board properly monitors the performance of service providers.	**T & R & S**

D. AUDIT

No	Objectives	TRUST ref
1.	Determine the degree of reliance that can be placed on the external audit function.	**T & R**
2.	Determine the degree of reliance that can be placed on internal audit functions.	**T & R**

E. FINANCIAL CONTROLS

No	Objectives	TRUST ref
1.	Determine what controls there are over fund transactions, including whether the Board has an adequate process to deal with the acquisition and disposal of assets.	**T**
2.	Determine whether the fund has an adequate crediting rate procedure, and whether it is applied in an objective manner.	**T & S**
3.	Determine whether the Board has in place adequate procedures to enable benefits to be correctly calculated and paid.	**T**
4.	Determine that the Board has in place adequate procedures of receipting contributions and transfers in and following up outstanding employer and member contributions.	**T**

F. INFORMATION TECHNOLOGY

No	Objectives	TRUST ref
1.	Determine whether the Board has considered and implemented satisfactory procedures for IT systems and for disaster recovery.	**T & R**

MODULE A: TRUSTEESHIP

OBJECTIVE A.1

Determine whether a process exists to appoint new board members and whether the Board has appropriate standards in place for responsible officers and other relevant personnel as well as for conflicts of interest and related party transactions.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine if the register of pecuniary interests is maintained and that board members are complying with the requirements of the relevant legislation.
- Determine how the Board ensures that all members have declared their interests.
- Review minutes of meetings to determine if appropriate declarations have been made.
- Determine what initial and ongoing procedures are in place to ensure that board members or responsible officers are not disqualified persons.
- Determine if board members are kept aware of their rights and responsibilities.
- Determine whether staff are required to disclose potential conflicts of interest.

OBJECTIVE A.2

Determine whether the Board has considered trustee indemnity insurance.

Guidance Notes

When reviewing this area the following points could be considered:

- Examine the process adopted by the Board to determine the level and adequacy of insurance cover that should be put in place by the Board.
- Examine the certificate of currency to see if cover is current.
- Determine whether there are any past or outstanding claims against the Board.
- Where no insurance is held, confirm how the adequacy of this arrangement was determined.

OBJECTIVE A.3

Determine whether the Board exercises adequate control over fund operations including sufficiency of board meeting arrangements and delegation structure.

Guidance Notes

This objective is intended to ascertain the Board involvement in fund operations. Other objectives involve a more specific overview of delegated functions; however, this objective should focus on the Board's maintaining responsibility for material decisions.

NOTE: where the Board has material services outsourced to external service providers or to related companies, refer to Module C.

When reviewing this area the following points could be considered:

- Determine if the assumptions used in the business plan appear reasonable based on past experience and current operations. Does the plan deal with:

  - Sources of growth
  - Marketing plans
  - Capital expenditure plans
  - Training and hiring of key staff
  - Budgets
  - Sensitivity of assumptions?

- Determine whether functions are in-house or external. i.e.. are these outsourced (e.g., IT, internal audit, custodian, etc,)

  - If functions are performed in-house determine whether there is an appropriate segregation of duties and functions.

- Determine that there are specific procedures manuals for different funds or different functional areas.
- Determine the delegation arrangements – both informal and formal, e.g., sub-committees. Obtain terms of reference for any such committees.
- Determine the adequacy of the delegation arrangements, i.e., terms of reference, performance criteria, and frequency of reporting and reporting requirements.
- Determine whether there are any conflicts of interest possible in the Board or service provider network and if so, determine whether there is a possibility that such conflict could have occurred and if the conflict was acknowledged and recognized.
- Determine what Board meetings have an involvement in either controlling or directing the operations of the fund (e.g., investment, compliance, management, audit committees and board of directors meetings).
- Determine the frequency of board meetings to consider updates/reports on the financial position of the fund, investment strategy, investment portfolio, compliance with the provisions of relevant legislation, compliance with internal controls, policies and procedures.

OBJECTIVE A.4

Determine whether the Board has adequate compliance and due diligence processes.

Background

As noted in Objective A.3 it is unlikely that the Board is able to perform or have direct involvement in all operations. As a result it is important that the Board has adequate procedures in place to ensure that responsibility is maintained over fund/ board operations.

It is good practice for the Board as board of the fund to establish a Compliance Committee, which reports direct to the board. The charter for such a Committee is often to ensure that adequate processes are followed by fund officers to ensure compliance with internal controls and various legislative requirements.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine what procedures the Board has for compliance monitoring and reporting including:

  - ➢ Proposed investment transactions
  - ➢ Payments to the Board from the fund (e.g., daily sitting allowances) and all payments to third parties
  - ➢ Standard reports and documents issued to members as required by the relevant legislation and advice whether any such material requires amendment
  - ➢ Verification of the existence and currency of contracts between the Board and service providers
  - ➢ Maintenance of procedures for compliance
  - ➢ Arrangements relating to beneficiaries' enquiries or complaints about the fund
  - ➢ Financial position of the fund
  - ➢ Compliance with internal controls, procedure manuals and delegations
  - ➢ Internal and external audit findings
  - ➢ Consistency of fund operations to relevant legislation
  - ➢ Procedures for reporting of non-compliance and for the follow-up and remedying of non-compliance.

- Determine who has responsibility for reporting on and monitoring adherence with the Board’s compliance procedures.
- Identify whether there is a compliance officer, the scope and nature of the functions of this officer, the lines of reporting and whether the position is independent of management.
- Determine what procedures are in place that are aimed at ensuring that proposals to the Board or major decisions made during the year comply with all legal requirements.
- Determine whether the due diligence process is formalized or is relatively ad hoc.

OBJECTIVE A.5

Determine whether the Board has adequate planning in place to focus on the long-term nature of members’ benefits.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether there is a business plan and whether it appears adequate and appropriate and is reviewed regularly to incorporate material industry changes, e.g., changes in legislation governing:

    - ➢ The proportion of funds to be placed overseas and managed by a funds manager.
    - ➢ The level of contributions from members.
    - ➢ The level of interest to be paid to members.

OBJECTIVE A.6

Determine if the Board minutes adequately document decisions made regarding the running of the fund.

Guidance Notes

The following are the main areas to be considered:

- Determine:

    - ➢ The frequency at which board meetings are held.
    - ➢ Who determines or how the agenda is developed.
    - ➢ Whether there are any regular agenda items.
    - ➢ Whether there are any prolonged absences of board members.

- Determine whether the degree of documentation is sufficient to demonstrate that the Board is completely in control of the operations and that there is adequate assurance that the Board has made properly considered decisions.

When reviewing the Board minutes, specific areas or indicators that should be considered include:

- ➢ Board appointment and review of service providers.
- ➢ Management of member complaints.
- ➢ Board considerations in the development or review of the investment strategy.
- ➢ Significant events.
- ➢ Reporting supplied by third parties (e.g., funds manager).
- ➢ Investment decisions and consideration of the crediting rate.
- ➢ Industry and market developments.

MODULE B. INVESTMENTS

OBJECTIVE B.1

Determine that the Board has an investment strategy in accordance with the provisions of the Act, a process for the review of the strategy, and that the Board invests in accordance with the strategy.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine how the Board developed, formulated and ratified the investment objectives and strategies.
- Determine how often the Board reviews the investment management guidelines for both international and domestic investments.
- Determine whether the Board considered the following (this is not exclusive):
    - Cash flows (both in and out)
    - Risk of investments
    - Diversification
    - Liabilities including the liability profile of the fund
    - Benefit structure of the fund
    - Member expectations
    - Age profile of members
    - Asset allocation ranges and benchmarks.
- Determine what performance review processes exist and the regularity of these processes.
- Determine whether the Board has documented policies in place in respect of fund transactions with related and unrelated parties.
- Determine whether investment operations are subject to review by:
    - Internal auditors,
    - External auditors,
    - Compliance officer,

  and whether this review includes regular checking to ensure that trading is within guidelines set by the Board/investment committee.

OBJECTIVE B.2

Determine whether the Board has appropriate risk management practices and that these are consistent with the fund's investment strategy (including, if appropriate, derivative usage).

Any company performing investment functions must be sure to identify, measure and manage the risks associated with investing. Three broad categories of risk include market risk, liquidity risk and credit risk.

***Market risk** refers to the possibility of loss due to change in prices in the market, be they stock prices, currency rates or interest rates. **Liquidity risk** is the risk of loss associated with a particular secondary market in which security trades due to lack of depth. An investment that can be bought or sold quickly and without a significant price concession is considered liquid. The more uncertainty about the time element and the price concession, the greater the liquidity risks. **Credit risk** refers to the risk that a counterparty to the contract may fail. For pension funds, apart from 'bad loans', this refers primarily to the risk of inadequate documentation.*

As distinct from objective B1, this area specifically covers board risk management practices/systems. Incorporated into the investment strategy will be the Board's assessment of the appropriate risk level for the fund.

As a result the Board must ensure that appropriate attention was given, and is given to risk assessment, giving the changes to funds over time, e.g., changing markets or changing membership.

Derivatives can assist the Board to effectively manage risk and volatility in the investments made for the fund. Derivatives can therefore be used to legitimately enhance returns for the fund without adding to risk. It should be noted that these financial tools could have an impact on the investment profile of the entity.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether the Board uses a risk management model – and whether this model considers issues such as sector ranges, levels of asset exposure, hedging strategies, legal risk, credit risk, liquidity controls, and documentation requirements for investments.
- Determine how the Board undertakes credit decisions and assesses credit processes, including on-going monitoring of exposures.
- Determine the role of the investment committee and the frequency of its meetings and level of reporting to the Board.
- Determine how the fund monitors the level of outstanding debt, including any schemes established by the Board to provide educational or micro loans to members.

Points to keep in mind when reviewing high-risk investments:

- Determine whether a risk assessment has been made, i.e., is the high-risk investment consistent with the investment strategy?

DERIVATIVES

- Determine whether the derivative exposure is direct or indirect.
- If the fund is exposed to derivatives through direct investment:
  - Determine whether the Board has a risk management statement (RMS) in place.
  - Comment on:
    - Whether the RMS makes it clear how the use of derivatives is a considered part of the implementation of the investment strategy that has been adopted for the fund;

    - ❖ Whether there are any limitations on the use of derivatives;
    - ❖ What systems are in place to ensure proper segregation of duties between the dealing and the settlement areas;
    - ❖ The procedures for revaluing and assessing the risk associated with the investment in derivatives;
    - ❖ The systems the directors have in place to monitor derivative exposure, including margin calls and the frequency of reports to directors on derivative use;
    - ❖ Conduct of stress testing and reporting to the Board;
    - ❖ Procedure in place for timely reporting of all breaches of derivatives investments to the Board;
  - ➢ How the Board is satisfied that the procedures set out in the RMS are being complied with?

- Determine what, and how often, reports on derivative exposure are received by the Board, what consideration is given to them by the Board and whether the reports reviewed comply with the reporting requirements set out in the RMS.
- Determine the Board understanding of derivatives as a financial tool.
- Determine whether there is over reliance on one individual and/or inadequate segregation.

FOREIGN INVESTMENTS

- Determine whether the Board has identified possible risks involved in foreign investment dealings of any type (i.e. bonds, equities, property, currency etc).
- Determine whether the Board has a foreign exposure management system in place:
    - ➢ Does this cover the means of determining the extent of their exposure (transaction and translation) at pre-determined frequency?
    - ➢ Does this indicate a passive or active management of foreign investment exposures?
    - ➢ Does the Board use foreign exchange options, futures, forwards or swaps to hedge against foreign investment exposure or take proprietary positions (for own account trading)?
    - ➢ Is the management system regularly assessed and reviewed to ensure that it is adequately coping with the current environment and the current level of exposure?

- Determine whether contingency plans exist to deal adequately with large fluctuations in foreign exchange markets (including ‘trigger events’) which will require notification.
- Determine whether the Board has a documented procedure to select the counterparties that they deal with for foreign exchange dealings, including setting up of counterparty dealing limits and a periodic review mechanism.

    - ➢ Determine what considerations have been made in developing this procedure and the extent of expert assistance, if any, taken.
    - ➢ Examine if the investment strategy as adopted accords with foreign exchange dealing policy.

- Determine the amount of foreign exchange business conducted with different counterparties over a recent period.

- Determine the nature and extent of reporting to the Board, including the impact of foreign currency exposure on domestic currency earnings during the recent years.

OBJECTIVE B.3

Determine whether any assets, loans granted or borrowings are in accordance with the current legislation and that all assets are maintained at arms-length.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine from the most recent financial statements whether there is evidence of lending to members.

- Determine from the most recent financial statements whether there is evidence of borrowing by the fund.

- Where potential non-arms-length investments have been identified, determine whether the investment is via arms-length arrangements and is maintained on an arms-length basis.

OBJECTIVE B.4

Determine that the assets of the fund exist, are appropriately valued, and are registered in the appropriate name.

Guidance Notes

Attention should be paid to various types of asset verification. For example direct property may entail title deed and possibility of any mortgage. Shares may be verified via direct third party confirmation, share scripts or automated systems. Also dividend receipts may provide additional evidence. Investment in fund managers may be verified via a single annual statement of the value held.

When reviewing this area the following points could be considered:

- Where applicable, determine whether the external auditor has satisfactorily verified the existence, value, custody and ownership of the fund assets.
- Identify the custodial arrangements for fund assets and confirm that there is a written agreement between the custodian and the Board. Consider:
  - Domestic investments.
  - Offshore investments (use of sub-custodians).

- If the custodian has been appointed by the investment manager rather than the Board then:
  - Determine whether the Board consented.
  - Determine whether the Board has obtained a copy of the investment manager's agreement with the custodian.

- ➢ Determine whether the investment manager has to obtain board consent prior to any changes being made in the custodian agreement.

- If sub-custodians are used, determine if the Board is aware of the detail of the arrangements; and that the sub-custodian agreement makes it clear that the custodian retains full liability for any acts or omissions of the sub-custodian.
- Determine if reconciliations are carried out between Board and custodian records on a regular basis and if any discrepancies revealed by these reconciliations have been resolved in a timely fashion.
- Determine whether the custodial procedures and systems in place are reviewed and signed off by the compliance function or the internal audit area, and whether any reports are presented to the Board for its consideration.
- Determine whether the custodian agreement requires that the custodian must have appropriate professional indemnity insurance in place and whether the Board checks on the currency of this insurance.
- Determine whether the custodian agreement requires the Board to authorize fee payments and whether these payments cannot be directly deducted by the custodian from the assets of the funds.

MODULE C. SERVICE PROVIDERS

OBJECTIVE C.1

Determine whether:

- *The Board has adequate due diligence procedures in place for selection of service providers;*
- *A comprehensive written agreement exists;*
- *The Board retains the responsibility for delegated tasks; and*
- *The Board properly monitors the performance of service providers.*

An important part of the use of service providers by boards is the prudent selection of the service providers. Whether the initial selection, selection due to re-tender, or selection due to poor performance of the previous service provider, the Board must ensure prudent selection. Due diligence is the formal process that boards must apply in discharging their duties.

It would be reasonable to assume that the Board reviews all possible candidates for performance of the selected function(s). In many cases an independent firm/consultant is engaged to conduct the assessment of potential service providers. In other cases the Board will directly assess candidates. Such review may encompass interviews and assessment of contracts. However, in all cases the Board must ensure that prudent procedures are followed. These procedures are known as due diligence procedures. Such procedures should be formally recorded and in most cases will involve various personnel.

Most significant functions delegated by the Board would require the existence of a written agreement to accurately ascertain the extent of functions delegated. The written agreement should clearly indicate the functions to be performed by each party and may specify performance standards, conditions whereby the agreement may be terminated, and as discussed further at Objective 4, may contain indemnification conditions.

The Board should maintain responsibility for the functions delegated. The Board should appropriately monitor the performance of each service provider. All service providers should provide the Board with reports indicating the performance of the particular function(s) undertaken.

To demonstrate proper control, the Board must have proper delegations and arrangements in place so that all tasks are carried out. Using service providers implies that arrangements must be properly documented with adequate legal certainty of the roles of each party. Service agreements must clearly define a number of issues that are outlined below. However, fund members must be adequately protected in the event that a service provider fails to perform its duties or meet its responsibilities.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether the Board has any procedures for the selection of service providers and whether these procedures have been documented.
- Determine whether the Board has current written agreements in place where it is has delegated duties and functions to:

  - ➢ Administrators;
  - ➢ Investment advisers;
  - ➢ Custodians; and
  - ➢ Others.

- Determine whether each agreement clearly sets out:

  - ➢ The duties and functions of the service provider;
  - ➢ That the agreement is consistent with provisions of relevant legislation;
  - ➢ That the service provider indemnifies the Board where they breach the agreement;
  - ➢ That the liability for loss or damages arising from any fraud or incompetent actions by the service provider (or their staff) lies with that service provider (and the liability is not limited);
  - ➢ There are clear instructions on who and how many persons are authorized to issue instructions to the service provider (and in what form the advice shall be given);
  - ➢ There are clear instructions on who and how many persons are authorized to amend the authorized signatories (and in what form the advice shall be given);
  - ➢ That the liability for loss or damages arising from the service provider acting on instructions from those other than authorized persons lies with the provider;
  - ➢ There are clear performance standards and the service provider is required to regularly report against these standards;
  - ➢ There is a requirement for disclosure of brokerage or commissions and the method for dealing with any such payments to the service provider;
  - ➢ The method and circumstances under which the contract may be terminated (and timeframes for notice to be given) are stipulated and consistent with the Act;
  - ➢ All records remain the property of the fund and on termination of the contract, all records are transferred in a specified format within a specified time;
  - ➢ The service provider has and maintains adequate professional indemnity insurance;

- The service provider, on a regular basis (e.g., monthly), certifies compliance with the provisions of the agreement; and
- The basis on which fees and charges are to be paid by the Board is stipulated.

- Determine how each service provider's performance against the agreement is controlled and monitored by the Board.

  - Consider types and frequency of reports.

MODULE D. AUDIT

OBJECTIVE D.1

Determine the degree of reliance that can be placed on external audit functions.

Guidance Notes

Issues to consider when determining the level of reliance that can be placed on the external audit function include:

- Determine how the external auditor satisfies the requirements of an approved auditor for the fund.
- Determine whether an audit engagement letter has been issued and the extent to which the Board understands the scope of the audit, including the audit testing to be undertaken.
- Determine the extent of testing undertaken and the extent of the documentation of audit procedures evidenced in the audit working papers.
- Determine the auditor's understanding of the fund's internal control environment.
- Determine whether a management letter has been issued, whether any weaknesses identified by the auditor have been raised with the Board in the letter, and whether the auditor is satisfied with the Board's response.
- Determine whether the auditor identified any compliance breaches that were not material.

OBJECTIVE D.2

Determine the degree of reliance that can be placed on internal audit functions.

Guidance Notes

Issues to consider when determining the level of reliance that can be placed on the internal audit function include:

- Determine the extent of any internal audit function. Consider:

  - "Independence" of the Internal Audit department.
  - Reporting lines.
  - Degree of access to the Chairman of the Board, General Manager and/or Audit Committee.

- Scope and focus of reviews – financial, operational, efficiency, and management reviews.
- Frequency of reviews.

- Determine how internal audit assignments are selected
- Determine whether any issues of significance were identified by internal audit.

MODULE E. FINANCIAL CONTROLS

OBJECTIVE E.1

Determine what controls there are over fund transactions, including whether the Board has an adequate process to deal with the acquisition and disposal of assets.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine what controls exist to minimize the risk of deliberate or inadvertent breaches of authorization limits.
- Determine what controls exist over cheque processing/approval.
- Determine whether there is timely execution of transactions including the allocation of funds for investment.
- Determine the use of automated systems; whether service contracts exist, and what controls such as passwords and identification codes are in place.
- Determine whether an audit trail is maintained in relation to all financial transactions.

Areas, which may require specific review, include:

- Determine if there are appropriate controls in place in respect of:

    - Authorization and payment of benefits;
    - Authorization and signing of cheques;
    - Receipt and recording of income;
    - Sensitive stationery especially pre-signed cheques; and
    - Bank reconciliations:

        - Reconciliations should be prepared by a person independent of the person maintaining the records (if size permits this is good practice - size may not always permit).
        - Reconciliations should also be independently reviewed and signed off.

    - Confirm how the Board controls:

        - The recording and banking of member money, whether received by hand or by post.

- Determine the time lag between the receipt of cheques and their deposit.

- Determine what procedures are in place for acquiring and disposing of assets, and whether these procedures:

    - Have been documented/recorded in minutes of board meetings and communicated to all relevant parties, and
    - Include authorization, supporting documentation, segregation of duties and the process of drawing cheques for the acquisition of assets.

- Determine the process and authorization required to change bank account signatories for accounts.
- Determine the process and authorization required to change authorized instructions to investment managers and collective investments.

OBJECTIVE E.2

Determine whether the fund has an adequate crediting rate procedure (this may include a unit pricing process or the use of reserves), and whether it is applied in an objective manner.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether the Board authorizes the crediting rate (should be after satisfaction of accuracy of annual review or financial statements).
- Determine if the Board complies with the requirements of current legislation and how the Board determines the crediting rate.
- Determine whether reserves are utilized for smoothing or payment of expenses.

OBJECTIVE E.3

Determine whether the Board has in place adequate procedures to enable benefits to be correctly calculated and paid.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether the Board has procedures for the payment of benefits and whether these procedures include:

    - Benefit authorization.
    - Timely execution of benefit payments.
    - Type of evidence required to be produced to satisfy the Board that benefits should be released.

- Determine the process used by the Board to:

    - Set crediting rates (interim and final),
    - Allocate investment earnings,

- ➢ Allocate expenses, and
- ➢ Assess whether these allocations to members are fair and equitable.

- Determine what procedures are in place to protect small amounts and amounts due to beneficiaries under the age of 18.

OBJECTIVE E.4

Determine that the Board has in place adequate procedures for receipting contributions and transfers in and following up outstanding employer and member contributions.

Guidance Notes

When reviewing this area the following points could be considered:

- Determine whether the Board receives regular reports that indicate the timeliness of the receipt of member and employer contributions.
- Determine whether contributions are received in accordance with actuarial recommendations.
- Determine the process by which contributions and their components are allocated to member accounts.

MODULE G. INFORMATION TECHNOLOGY

OBJECTIVE G.1

To determine whether the Board has considered and implemented satisfactory procedures for IT systems and for disaster recovery.

Guidance Notes

When reviewing IT systems, the following areas could be considered.

- Determine the existence of disaster recovery and business recovery plans and whether these plans are endorsed by the Board and are tested regularly.
- Determine the level of detail of the plan.
- Determine what computer systems are used in the administration of the fund, what is the extent of their use, what is the Board's assessment of their sufficiency, where the system was developed in-house, and whether there are controls over programming changes.
- Determine what fraud controls are built into the system to address:

  - ➢ Access privileges and restrictions
  - ➢ Password security
  - ➢ unauthorized access controls.