INTRODUCTION TO HANDBOOK

The bank examination process is the Central Bank of Iraq's fact-finding arm in discharging its regulatory and supervisory responsibilities. The essential objectives of an examination are (1) to provide an objective evaluation of a bank's soundness and compliance with banking laws and regulations, (2) to permit the Central Bank of Iraq to appraise the quality of management and directors, and (3) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, rulings, and regulations. To accomplish these objectives, the examiner should evaluate the prudency of the bank's practices, the bank's adherence to laws and regulations, the adequacy of the bank's liquidity and capital, the quality of the bank's assets and earnings, the nature of the bank's operations, and the adequacy of the bank's internal control and internal audit. The scope of an examination may cover every phase of banking activity, or it may concentrate on specific areas that deserve greater emphasis because of their potential effect on a bank's soundness.

ABOUT THIS MANUAL

The goal of the Examination Handbook is to organize examination objectives and procedures that provide guidance to the examiner, and to enhance the quality and consistent application of examination procedures. The manual provides specific guidelines for:

- Determining the scope of an examination;
- Determining the procedures to be used in examining all areas of a bank, including those procedures that may lead to the early detection of trends that, if continued, might result in a deterioration in the condition of a bank;
- Evaluating the adequacy of the bank's written policies and procedures, the degree of compliance with them, and the adequacy of its internal controls;
- Evaluating the work performed by internal and external auditors;
- Evaluating the performance and activities of management and the board of directors
- Preparing workpapers that support examination reports and aid in evaluating the work performed; and
- Using objective criteria as a basis for the overall conclusion, and for the resulting comments and criticism, regarding the condition and quality of the bank and its management.

The examiner-in-charge must properly plan and organize the examination before work begins. Initial decisions concerning examination scope can usually be made based on the nature of the bank's operations; its size; the past experience of the examiner-in-charge with the bank; information in the previous examination report, including the condition of the bank at that examination; communications with the bank between examinations; and analysis of reports submitted on a periodic basis to the Central Bank of Iraq. The planning of work and pre-examination procedures are covered in the Examination Planning section of this manual.

Examiners should view the manual as a working tool rather than as a reference manual. In most sections of the manual, examination procedures and internal control questionnaires are provided to form the basis for the examination of a bank. These procedures should lead to consistent and objective examinations of varying scopes. The bank's condition is disclosed by the performance of examination procedures, including review of internal controls and audit function, and the evaluation of the results thereof, not by the examiner's judgment alone.

For larger banks, additional examination procedures may need to be incorporated into the process to effectively examine those institutions' complex organizational reporting and accounting systems. Conversely, some of the procedures contained in this manual do not apply to smaller sized banks. Additionally, local characteristics necessitate supplemental procedures. For example, specific

procedures relating to various types of agricultural lending have not been developed in this manual. When modifying the procedures, the examiner-in-charge is responsible for determining that the examination objectives are met and that the examination meets the needs of the individual bank.

The manual is also intended to guide examiners in their efforts to encourage banks to develop written policies and related procedures in all areas where none exist, and to correct situations where there are deficiencies in or a lack of compliance with existing procedures. To aid the examiner, this manual includes topics such as loan portfolio management, asset and liability management, earnings analysis, and capital analysis. A section on the appraisal of bank management guides the examiner in assembling and evaluating information from all other manual sections and helps uncover inconsistencies in the application of bank policies among various management groups. Examiners should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow the best practices that currently exist in the banking industry. In no case, however, should this approach discourage the development and implementation of conceptually sound and innovative practices by individual banks.

Although this manual is designed to provide guidance to the examiner in planning and conducting bank examinations, it should not be considered a legal reference. Questions concerning the applicability of and compliance with Iraq laws and regulations should be referred to appropriate legal counsel. In addition, the manual should not be viewed as a comprehensive training guide. Separate training programs provide more detailed instructions to assist the examiner in better understanding banking operations and applying examination procedures.

HOW TO USE THIS MANUAL

Organization

Sections in each part are made up of four or five subsections, where applicable. They are:

- An introduction;
- Examination objectives;
- Examination Procedures;
- Internal Control Questionnaires; and
- Verification Procedures.

The introductions, for the most part, summarize the respective topics. The examination objectives describe the goals that should be of primary interest to the examiner. Two of the objectives determine the scope of the examination for the specific area of examination interest. They are (1) the evaluation of the system of internal control and of bank policies, practices, and procedures, and (2) the evaluation of the scope and adequacy of the audit function. Other common objectives are to determine compliance with laws, regulations, and rulings, and to determine the need for corrective action.

The examination procedures include procedures to be performed during a full-scope, comprehensive examination. In some instances not all of the procedures apply to all banks; examiners may exercise some flexibility depending on the particular characteristics of the bank under examination. The materiality and significance of a given area of bank operations are the examiner's primary considerations in deciding the scope of the examination and the procedures to be performed. Examiner flexibility results in examinations tailored to fit the operations of the bank.

The evaluation of a bank's internal control environment should encompass a review of the internal audit activities and the implementation of selected internal control questionnaires (ICQs), which set forth standards for operational control. Due to the difference between an examination and an audit, it is not contemplated that all ICQs will be implemented in any one examination. The body of ICQs used during the course of the examination should be made up of three elements: (1) those mandated

for all examinations, (2) those selected by the examiner-in-charge based upon experience, knowledge of problems within the bank, and perception of risk, and (3) those that focus on areas where on-site evaluation of operational control appears warranted in light of the results of the examination of internal audit activities. In addition to serving as a guide during on-site evaluations, the ICQs can be used in the appraisal of operational audit techniques in banks where the scope of internal auditing includes such considerations. The ICQ steps marked with an asterisk require substantiation by observation or testing; they are considered to be fundamental to any control program regardless of the size of the institution. These steps should be incorporated in management control programs in smaller banks to compensate for the absence of internal auditing.

Certain sections of the manual also contain verification procedures. These procedures are to be utilized in the event internal/external audit programs are insufficient. The procedures then require the examiner to physically verify the existence of assets or liabilities.

Numbering System

The manual is arranged using a numbering system based on the manual's sections and subsections. For example, the introduction subsection of the Other Assets/Other Liabilities section is numbered 299.1. The examination objectives subsection for that section is numbered 299.2, and so on. Subsections are always numbered consecutively regardless of the number of subsections within a particular section.

Introduction

It is essential to carefully plan an examination so that it will be as effective and as efficient as possible. A decision must be made on whether the examination will be a "surprise" or whether the bank should be given advance notification. Surprise examinations are generally necessary when:

- There is an indication of fraud, embezzlement or some other criminal activity;
- The bank's internal audit and controls are considered unacceptable;
- The CBI deems an unannounced examination is necessary.

Whenever the CBI informs the bank about an examination in advance, the bank should be required to prepare all necessary information in advance thereby saving the CBI supervisory time and resources.

Ordinarily, the pre-examination preparation is performed by the examiner-in-charge (EIC) and one or more team members, depending on the size of the bank and the scope of examination. Time requirements for this preparation may last from one day up to two weeks (depending on the size of the bank or nature of examination). The pre-planning memorandum should be approved by the Director of Bank Supervision and should address the following:

- Examination objectives;
- Scope of examination;
- Main areas of review;
- Procedures for the monitoring of examination work, allocation of human resources, timeframes, and duration of examination;
- List of documents necessary for examination.

Examination Objectives

Examination objectives should be defined based on analysis of certain factors; for example, the objectives should relate to the current financial condition of the bank, transactions/operations and their results, economic environment, results of the last examination, and results of off-site analysis of financial statements and regulatory reports.

Scope of Examination

When defining the scope of the examination, examiners should review or determine the following:

- Review all available analysis, including analysis of regulatory reports;

- Review previous examination reports, correspondence, minutes, memoranda and other documents of examination significance;

- Determine subsidiaries that are to be examined and the scope of such examination;

- Determine cutoff lines (e.g. loans of 1 mln. IRD and more) to be used for areas of review (e.g. loans, deposits, investment securities, etc.), or appropriate sampling techniques;

- Determine items to be included within a request-letter and the date by which the bank should provide the data to the Supervisors;

- Review the list of bank services. A survey of services offered by a bank can be useful in examination planning as it is important for examiners to have an understanding about new or

discontinued services which could affect the scope and direction of the examination. The listing should be continuously updated and may be utilized during future examinations.

Main Areas of Review

At the pre-planning stage it is crucial to identify those areas of the bank's operations that are vulnerable and sensitive to risks. During the examination these areas should undergo a thorough investigation.

While performing the evaluation of risk areas, the examiners should find out what changes were made or are expected to be made since the last examination that may have an impact on the bank's financial condition, e.g. new services rendered by the bank, changes of management principles, changes of market conditions, and other economic phenomena.

Monitoring of Examination Work

Effective management of an examination includes:

- Determining the number of examiners necessary for review;
- Defining timeframes of examination;
- Exact matching of responsibilities, authorities, and distribution of work;
- Reviewing workpapers to ensure that they support the conclusions reached in the related report of examination;
- Monitoring overall examination to ensure completion of all necessary procedures and workpapers.

Assignment of Personnel and Segregation of Duties

Budgeting and allocation of human resources by the examiner-in-charge requires work experience, consideration of the scope of the examination, and professional knowledge of participating examiners. The examiner-in-charge also must consider the accessibility of the bank's accounting and other records and the degree of assistance and cooperation of bank management.

In order to plan and control the work of the examination the EIC should draft a "time-schedule of work". The summary should be organized on a basis consistent with the structure of the sections contained in this manual. Accordingly, it should specify the areas subject to review and provide for the number of examiners and working hours necessary for examination of each area. The examiner-in-charge should assign priorities to areas under review. Budgeted hours for each area can then be estimated based on the experience gained from past examinations, modified by changes in scope, number of examiners, etc. The estimated hours for all areas should then be compared to actual results. This comparison should become a tool for the EIC to control the work of examination team members. Upon completion of the examination, the EIC should submit a written explanation to the Director of Supervision explaining any significant variances from the plan.

When assigning various examination categories, the examiner-in-charge should also consider the organization of the bank and interrelationship between sections of this manual. For example, the "Investments" area of a bank will more than likely impact procedures utilized in the "Funds Management" section. Accordingly, it may be most efficient to assign those sections to a single examiner, provided, of course, that they are not voluminous and that it will not affect the examiner's productivity.

Budgeting and allocation of human resources should also include the following considerations:

- Assignment of examining personnel in a manner to maintain an even workload throughout the examination;
- Allocation of assignments to examiners having adequate knowledge, and, if possible, specialized in the given area;
- Allocation of assignments, which will permit the development and training of the examination staff.
- Avoidance of duplication;
- Following of assigned priorities.

Once the examination has commenced, the examiner-in-charge must monitor and coordinate the performance of the examination team and individual examiners, and, if necessary, assist them in making additional inquiries in order to gain a full understanding of the work performed.

Documents Necessary for Examination

At the pre-planning stage the examiner should study a wide range of documents some of which are available at the CBI, while some will need to be requested from the bank. Therefore, the pre-planning should start at least 5 weeks prior to the examination. The first week, the examiner should study the documents available on the bank at the CBI. Afterwards, or parallel to reviewing those documents, the examiner should request other necessary documents from the bank. The bank should provide all necessary documents at least 1 week prior to the examination.

Below are listed some of the documents that the examiner should review prior to the examination

1. All monthly statements on compliance with prudential regulations or instructions from the CBI.
2. Quarterly analysis of the bank's financial condition, annual financial statements, data subject to mandatory publication, the latest balance sheet and income & expense statement
3. Latest statements on liquidity
4. List of the bank's shareholders and owners
5. Results of the last full scope examination and all subsequent targeted examinations (including results of implementation of all instructions issued to the bank upon completion of examination).
6. All the correspondence between the CBI and the bank since the last full scope examination. Some of these documents refer to the problems that existed in the bank and their solutions; others may refer to the penalties imposed by the CBI. It is of crucial importance for the examiner to be aware of the actual relationships between the bank and the CBI.
7. Complaints against the bank received since the last complex examination. It is important for the examiner to be aware of complaints received from the customers. This will allow the examiner to draw conclusions on the management quality of the bank.

Scrutiny of the above mentioned documents would permit the examiner to define the scope and direction of the examination. Once this is achieved, the examiners should discuss the upcoming examination with bank's management (if not a surprise examination). This discussion should immediately be followed with an official letter to the bank providing official notification of the examination and addressing the following:

- Documents the examiners would like to receive at the beginning of the examination;
- Scope of the upcoming examination;
- Approximate number of examiners participating in the examination;
- Duration of examination.

At the pre-examination discussion of the examiner with bank's management he/she should find out what changes have occurred since the last examination in the general policy of the bank, nature of

operations, decision-making process, and new services rendered by the bank. They should also discuss risk management processes, the most risky area of the bank's activities in the opinion of the bank's management, and expectations of bank's management concerning the future development of the bank.

Documents necessary for examiners once they start the examination include the following:

1 Internal reports disclosing the classification of all assets (specifically loans) according to the CBI defined risk categories;
2 Loan committee minutes since the last complex examination. If a bank does not have such a committee, minutes of meetings of other responsible functions should be reviewed.
3 Asset/Liability committee minutes. If a bank does not have such a committee, minutes of meetings of other responsible functions should be reviewed.
4 Board of Directors minutes and minutes for committees not specifically mentioned above.
5 Internal and external audits conducted since the last examination. The documents should include the reports (including management letter if external audit), identified deficiencies and violations, recommendations made as well as the corrective actions taken by management.

In addition to the above, the examiner should already have determined, during the pre-examination planning, which pro-forma workpapers will need to be submitted to the bank for their completion. These should be completed by the bank prior to the examination start date. If a surprise examination, on the first day of the examination, the supervisors should provide selected pro-forma workpapers to the bank for their immediate completion along with a deadline for returning the information to the supervisors.

The planning of examination work is performed before the commencement of the examination and during the examination as revision to the plan might be necessary. Changes to the initial plan should be approved by the Director of Bank Supervision and documented in the workpapers.

OBJECTIVES

1. To determine the examination procedures to be utilized and the extent of testing.

2. To determine personnel requirements and to organize and coordinate human resources to attain optimum utilization and to supplement formal education programs.

3. To develop and communicate formal plans to promote efficiency throughout the examination process.

Format For Examination Planning Memorandum

1. General Information on the Bank

- Name of the bank
- Location of the bank
- Starting date of pre-planning
- Ending date of pre-planning
- Examiner in charge
- Date of last examination
- Type of last examination (full-scope or targeted)
- Duration of last examination (number of days)
- Number of examiners at the last examination
- Total size of assets, including:
    - Total size of loan investments,
    - Types of loans
- Total size of liabilities, including:
    - Total size of deposits,
    - Types of deposits
- CAMEL composite composite and component rating
- Current Compliance with Regulations:

  (List regulation requirements such as capital and liquidity)

- List of penalties applied or sanctions initiated against the bank (type of sanction and date of initiation)
- Projected date of the examination
- Number of examiners
- Projected duration
- Type of examination

II. Scope of Examination and Justifications

This section should contain the examiner's recommendations for the upcoming examination. The examiner should present information acquired on the bank during the pre-planning and, based on this information, clearly describe how he/she is going to conduct the examination. (It is the examiner who should decide on the scope of examination). Particularly, areas with higher risks should be highlighted. The examiner should provide sound justification for the necessity of indepth analysis of a specific area. He/she should also define the timeframe necessary for the

employees to examine the given area and the number of examiners who will conduct specific work. Information should be provided in the following order:

Background

This section should include:

- Licensing Date
- List of major shareholders or group of shareholders
- Niche of the market, which the bank fulfills or is attempting to fulfill.
- General history of the institution during the last five years and whether any problems are apparent. Here, general background information should be provided.
- Notation as to whether management of the bank has been responsive to criticisms and recommendations noted in previous reports of examination.

Examination Areas

Each area mentioned below consists of two items. The first item deals with the findings of the pre-examination work. The second projects the scope of review, along with relevant justifications. Thus, the scope of review is contingent upon the findings. For example, if violations of law are noted and enforcement actions initiated, the examiner should focus his/her attention on several issues: what is the current status of compliance, how the current negative trend occurred, what are actions undertaken by management for correcting these violations, are these actions adequate, or if other actions should be taken to correct the deficiency, etc.

Cash (# of Workdays)

Findings

- Problems identified during the last examination.
- Problems identified by internal/external audit.
- Problems identified as a result of off-site reviews.

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination by internal/external audit or through off-site reviews.
- Determine the scope and effectiveness of cash reviews conducted by internal/external audits.
- Evaluate effectiveness of internal controls; ascertain that dual control system is established over the bank's vault, e.g. ascertain that neither the chief executive officer, nor any other person is authorized to access the vault if not accompanied by an employee responsible for the vault.

- If internal controls for cash are deficient, count existing cash and compare it with general ledger.

Due From Banks (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit
- Problems identified as a result of off-site reviews

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination by internal/external audit or through off-site reviews.
- Review internal policies and procedures regulating correspondent relationships of the bank.
- Ascertain that funds on correspondent accounts are reconciled on a regular periodic basis and outstanding amounts are clarified in the shortest period of time.
- Determine reasons and reasonableness of opening various correspondent accounts.

Investments in Securities (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit
- Problems identified as a result of off-site reviews

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination by internal/external audit or through off-site reviews;
- Determine the number of pledged securities.
- Determine the value and quality of securities portfolio.
- Check the supporting documents for purchase of securities.

Loans (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit
- Problems identified as a result of off-site reviews

Scope of review

- The examiner should specify the volume, number and the minimum size of credit to be reviewed. For example, the examiner may state that he/she is not going to examine credits below 500,000 IRD. If loans are deteriorating as demonstrated by increasing level of past-dues, loan extensions, losses, management fraud, etc., the examiner would want to review a high percentage of the loan portfolio. The examiner will not want to ignore smaller credits and should indicate in the plan how these will be reviewed perhaps utilizing a uniform approach.
- If pre-planning discloses that management practices are highly questionable, the examiner will need to define a scope, which ensures that any tricks being utilized by the bank will be discovered. This might require the examiner to state in the scope that all loans above a certain amount should be reviewed in detail, as well as all loans extended to bank related parties.
- It is of crucial importance to review the loan policy for adequacy and compliance. The examiners should find out the level of compliance of the bank's management and staff with the loan policy in their daily transactions, as well as compliance of the loan policy with the criteria defined by the CBI. If the previous examination disclosed non-compliance, the supervisor should include within the scope of examination the requirement to determine whether those instances of non-compliance have been corrected in addition to whether other violations of the policy are now evident.

Fixed Assets (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit (e.g. issues of revaluation of fixed assets and accurate reflection of their values in the balance sheet);
- Problems identified as a result of off-site reviews

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination by internal/external audit or through off-site reviews;
- Review documents supporting acquisition of fixed assets since the last examination;

- Determine accuracy of revaluation of fixed assets;
- Ascertain that acquired fixed assets are used by the bank and not by the bank's shareholders;
- Ascertain that fixed assets acquired from related organizations were not purchased at a price higher than market price.

Other Assets (# of Workdays)

Examiners should be careful while reviewing the "other assets" section, since the bank may record/ hide any amount.

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit;
- Problems identified as a result of off-site reviews

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination by internal/external audit or through off-site reviews;
- Review quality of other assets;
- Review policies and procedures for other assets;
- Determine whether bank employees comply with these policies and procedures.

Capital & Liabilities (# of Workdays)

Findings:

- Problems or outstanding issues from licensing and registration addressing liabilities and capital;
- Conclusion of last Report of Examination and recommendations;
- CBI instructions or recommendations;
- Trends noted as a result of analysis of regulatory reports;
- Capital plans forecast in Business Plan and its assessment;

- Current or past enforcement actions initiated against the bank addressing liabilities and capital.

Scope of Review:

- Review of changes in capital structure
- Verification that capital violations and normative deficiencies have been corrected
- Assessment of capital given the findings of the examination.

Management (# of Workdays)

Findings

- Comments and criticisms of management within the previous full scope examination and subsequent targeted examination reports
- Current or past enforcement actions related to management and the management bodies.
- Changes in management since the last examination. Obtain information on management and past work experience. If worked at other banks, the supervisor should evaluate the performance of the management person at other institutions. This information should be obtainable from CBI Supervision Department.
- Procedures for development and approval of policies and procedures for all areas of the bank.
- Management's attitude towards delegation of authority or whether management retains control over all operations of the institution

Scope of Review

- Review organizational structure of institution
- Review any changes in management between examinations. Facts and new data disclosed during pre-planning are of high importance. Examiners need to review in detail work performed by new management of the bank, especially when current management previously created problems at another institution.
- Determine from other examiners the quality of management control over respective areas such as loans, investments, fixed assets, etc.
- Determine the extent of management connections with related parties and with the shareholders of the institution.

- Determine whether management has influence over internal controls and/or activities of internal audit function.

Earnings and Expenses (# of Workdays)

Findings

- Listing of findings of previous full scope and targeted examinations. If the finding is poor earnings, then this memorandum should state what are the most significant contributing factors. If it is loss provisioning, the comment should analyze the provisioning impact upon earnings.

- Listing of significant issues and trends, which are evident from review of regulatory reports. If the full scope examination indicated poor earnings, then the financial analysis should reflect whether the poor earnings have continued and what the overriding reason has been.

Scope of Review

- Analyze the bank's earnings position and identify any unusual fluctuations;

- Determine accuracy of information contained in financial statements and consistency in applying accounting policy;

- Determine adequacy of policies, internal controls, accounting policy for earnings and expenses.

Liquidity (# of Workdays)

Findings

- Adequacy of liquidity noted in complex and targeted examination reports;

- Violations of regulations issued by the CBI;

- Liquidity policy, violations and reasons behind violations;

- Enforcement actions – both past and enforcement documents currently in use

- Gap analysis and trends

- Observations from off-site monitoring regarding the liquidity level of the bank

- Determination of projected sources and uses of funds for 90 days to determine their impact upon liquidity 90 days out.

Scope of Review

- If liquidity policy exists, conduct a thorough review to determine compliance with the policy.
- Determine liquidity position of institution. To include a review of the past, present and projected future.
- If liquidity is deteriorating, review the balance sheet to determine the actions taken by the institution, which are contributing to a weakening liquidity position.
- Determine if liquidity cycles matches the type of lending the bank is conducting.

Related Parties (# of Workdays)

Findings

- Problems identified during the last examination;
- Status of corrective actions required of the bank
- Problems identified in off-site reviews or internal/external audits

Scope of review

- Review any corrective actions taken to resolve problems identified during the last examination, by internal/external audit or through off-site reviews;
- Review internal policies and procedures regulating operations with related parties;
- Determine whether there are any violations of law and regulations in transactions concluded with related parties.

Computer Systems/Information Systems (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit;
- Problems identified as a result of off-site reviews

Scope of Review

- Check adequacy of internal information security
- Check the extent to which the bank is equipped with computer hardware and software

Legal Proceedings and Other Legal Disputes (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit;
- Problems identified from correspondence between the bank and the CBI.

Scope of Review

- Obtain a listing of current litigation initiated against the bank
- Obtain a listing of current litigation initiated by the bank
- Review reasons behind litigation
- Determine the extent of contingent liabilities due to existing litigation, whether the amounts are large and may have a significant influence upon the banks earnings and financial condition.

Off-Balance Sheet Transactions (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit;
- Trends identified in off-balance sheet items, e.g. growth of guarantees provided

Scope of Review

- Review the adequacy of policies and procedures regulating off-balance sheet transactions
- Determine if bank employees are governed by these policies and procedures
- Check accuracy of risk classification of off-balance sheet items

Verification of Accuracy of Regulatory Reports (# of Workdays)

Findings

- Problems identified during the last examination
- Problems identified by internal/external audit;
- Listing of violations and enforcement actions recorded since the last examination.

Scope of Review

- Review accuracy of last regulatory reports
- If necessary review regulatory reports of previous periods for accuracy
- Review procedure of regulatory report preparation
- Monitor correction of identified inaccuracies.

Internal/External Audit and Internal Controls (# of Workdays)

This is an area of the examination, which usually warrants a close scrutiny, regardless of previous examination work. An early review during the initial stages of an examination may disclose areas which are adequately controlled. It may then be possible for the examiners to scale back part of their examination work in order to save time and CBI resources. It is also possible that the review may disclose that areas which previously were thought to be less risky actually contain a higher than acceptable level of risk. In this case, the plan of examination may have to be expanded thereby requiring discussions with CBI management to increase the staffing levels or the amount of time allotted to the examination of the bank.

Findings

- Issues reflected in the reports of previous full scope and targeted examinations
- Current status of the audit and internal controls as compared to the previous examination. This information may be obtained from written correspondence between the CBI and the institution.
- It is critical to know whether the internal auditor or the external audit firm has changed.

Scope of Review

- Review the internal audit plan, the audit workpapers, recommendations to management and verification of whether corrective action has actually occurred.
- If there have been changes in internal audit personnel, the examiner should determine the reason for the change
- Identify whether this change has had a negative or positive impact upon the bank.

III. Examination Budget

Once the scope of the work is defined, the Examiner-in-charge (EIC) needs to establish a projected budget for the work to be performed. The number of days allotted to the examination should be the total of days for each area of the examination (noted above). The below schedule should be completed and then examination performance against the budget monitored during the entire examination process. If it becomes necessary to significantly deviate from the budget, the EIC should explain and justify the matter fully to CBI management before the expenditure of

additional resources. No significant expansion of the budget should occur without the explicit approval of CBI Bank Supervision Management.

Area of Review	Number of total days to be expended

Format For Examination Planning Memorandum

1. General Information on the Bank

- Name of the bank
- Location of the bank
- Starting date of pre-planning
- Ending date of pre-planning
- Examiner in charge
- Date of last examination
- Type of last examination (full-scope or targeted)
- Duration of last examination (number of days)
- Number of examiners at the last examination
- Total size of assets, including:
    - Total size of loan investments,
    - Types of loans
- Total size of liabilities, including:
    - Total size of deposits,
    - Types of deposits
- CAMEL composite composite and component rating
- Current Compliance with Regulations:

  (List regulation requirements such as capital and liquidity)

- List of penalties applied or sanctions initiated against the bank (type of sanction and date of initiation)
- Projected date of the examination
- Number of examiners
- Projected duration
- Type of examination

II. Scope of Examination and Justifications

Background

Examination Areas

Cash (# of Workdays)

Findings

Scope of review

Due From Banks (# of Workdays)

Findings

Scope of review

Investments in Securities (# of Workdays)

Findings

Scope of review

Loans (# of Workdays)

Findings

Scope of review

Fixed Assets (# of Workdays)

Findings

Scope of review

Other Assets (# of Workdays)

Findings

Scope of review

Capital & Liabilities (# of Workdays)

Findings:

Scope of Review

Management (# of Workdays)

Findings

Scope of Review

Earnings and Expenses (# of Workdays)

Findings

Scope of Review

Liquidity (# of Workdays)

Findings

Scope of Review

Related Parties (# of Workdays)

Findings

Scope of review

Computer Systems/Information Systems (# of Workdays)

Findings

Scope of Review

Legal Proceedings and Other Legal Disputes (#of Workdays)

Findings

Scope of Review

Off-Balance Sheet Transactions (# of Workdays

Findings

Scope of Review

Verification of Accuracy of Regulatory Reports (# of Workdays)

Findings

Scope of Review

Internal/External Audit and Internal Controls (# of Workdays)

Findings

Scope of Review

III. Examination Budget

Area of Review	Number of Man-Days

INTRODUCTION

This section provides guidelines to assist the examiner in understanding and evaluating the objectives of, and the work performed by, internal and external auditors. It also sets forth general criteria that may be considered by the examiner in determining if the work of internal and external auditors is acceptable.

Internal Audits

Traditionally, the primary objectives of the internal audit function in the banking industry were the detection of irregularities and the determination of compliance with a bank's policies and procedures.

However, the responsibilities of internal auditors have expanded to include the appraisal of the soundness and adequacy of accounting, operating, and administrative controls. Such appraisal is intended to ensure that those controls provide for the prompt and accurate recording of transactions and the proper safeguarding of assets. In addition, internal auditors often have the responsibility of participating, when appropriate, in the formulation of new, and the revision of existing policies and procedures. Such participation ensures that adequate safeguards and controls, including appropriate evidential matter and audit trails, are provided during the planning and implementation process. Additional responsibilities of internal auditors may also include determining the bank's compliance with applicable laws, rules, and regulations; evaluating the effectiveness of administrative controls and procedures; and evaluating the efficiency of operations. That latter responsibility is often referred to as operational auditing.

The major factors that must be considered by the examiner in reviewing and evaluating the internal audit function are the competence and independence of the internal auditors and the adequacy and effectiveness of the audit program.

Competence of Auditors

The responsibilities of internal auditors and their qualifications will vary depending on the size and complexity of a bank's operations and on the emphasis placed on the audit function by the directorate and management. In many banks, the internal audit function is performed by an individual or group that has no other responsibility. In large banks, the chief auditor is often a manager who fulfills his or her responsibilities through the work of other people. In other banks, particularly smaller ones, the responsibility for internal audit may be placed with an officer or employee designated as a part-time auditor. In yet other instances, several employees may divide the audit responsibility. Internal auditors often are responsible directly to the board of directors, or a committee thereof, rather than to management. The qualifications discussed below, therefore, should not be viewed as minimum requirements, rather, they are intended to be matters that the examiner must consider in evaluating the work performed by the specific internal auditors or audit departments.

The manager of an internal audit department should have qualifications that may not be found in all the members of the audit staff. The examiner should expect, for example, to find that the manager of internal audit:

- Possesses a college degree with a business major or comparable business experience.

- Is committed to a program of continuing education and professional development.

- Has audit experience and possesses organizational and technical skills commensurate with the responsibilities assigned.

- Demonstrates an ability to communicate with others, both orally and in writing.

To fully understand the flow of data and the underlying operating procedures, the internal audit department manager must possess the proper education and training. College courses are one source, however, adequate education may be achieved through participation in courses sponsored by industry groups or through in-house training programs. Significant work experience in various departments of a bank also may provide adequate training. Certification as a Chartered Bank Auditor, Certified Internal Auditor or Certified Public Accountant serves as evidence of meeting the educational requirements. In addition to prior education, the auditor should be committed to a program of continuing education that may include attending technical meetings and seminars and reviewing current literature on auditing and banking. The auditor's organizational skills should be reflected in the audit program and its effectiveness. Technical skills may be demonstrated through the use of techniques, such as internal control and other questionnaires, testing (including statistical sampling), flowcharting, and computer programming.

In considering the qualifications of the audit staff, the examiner should review the educational and experience qualifications required by the bank for the position to be filled in the audit department and the training available for that position. In addition, the examiner must be assured that any member of the audit staff functioning as a supervisor possesses an adequate knowledge of audit objectives and an understanding of the audit procedures performed by the staff.

In a small bank, it is not uncommon to find that the internal audit, whether full or part-time, is a one-person department. Such an auditor may plan and perform all audits personally, or may direct staff borrowed from other departments. In either case, the examiner should expect, as a minimum, that the auditor possesses qualifications similar to those of a staff supervisor as described above.

The final measure of the competence of the internal auditor is the quality of the work performed and the ability to communicate the results of that work. Accordingly, the examiner's conclusions with respect to an auditor's competence also should reflect the adequacy of the audit program and the audit reports.

Independence of Auditors

The ability of the internal audit function to achieve its objectives depends, in large part, on the independence maintained by audit personnel. Frequently, an indication of the auditor's independence may be obtained by determining where he or she is located, administratively, within the organization and to whom, or to what level, he or she reports the results of the work performed. In ideal circumstances, the internal audit function is under the direction of the board of directors or a committee thereof. That enables the audit function to assist the directors in fulfilling their responsibilities.

An analysis of the reporting process followed by the auditor and of the findings and recommendations in the audit reports also is important in determining the auditor's duties. The auditor should be given the authority necessary to perform the job. That authority should include free access to any records necessary for the proper conduct of the audit.

Internal auditors must maintain independence in appearance as well as in fact. Accordingly, they should be instructed in the standards they are required to meet in their individual behavior and in the performance of their field work.

Program Adequacy

The factors that should be considered in assessing the adequacy of the audit program are:

天 Scope and frequency of the audit work.

天 Documentation of the work performed.

天 Content of the audit programs.

天 Conclusions reached and reports issued.

The scope of the program of internal audit must be sufficient to attain the audit objectives. The frequency with which the audit procedures are performed should be based on an evaluation of the risk associated with each area of audit interest. Among the factors that the auditor should consider in assessing risk are the nature of the specific operation and related assets and liabilities, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

There must exist a documented record of the work performed. Such a record is best created through the completion of audit working papers. The examiner should expect such working papers to contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached.

Although audit work programs are an integral part of the working papers, they are sufficiently important to deserve separate attention. Work programs serve as the

primary evidence of the audit procedures performed and, as such, they should be written and should cover all areas of a bank's operations. Each program should provide a clear, concise description of the audit work required, and individual audit procedures should be presented in a logical manner. The detailed procedures included in the program will vary depending on, among other factors, the size and complexity of the bank's operations. In addition, an individual audit work program may encompass several departments of the bank, a single department, or specific operations within a department. Most audit programs, however, will include procedures similar to those contained in the CBI's verification programs, such as:

天 Surprise examinations, where appropriate.

天 Maintenance of control over records selected for audit.

天 Review and evaluation of the bank's policies and procedures and the system of internal control.

天 Proof of detail to related control records.

天 Verification of selected transactions and/or balances through procedures, such as:

--Examination of supporting documentation.

--Direct confirmation and appropriate follow-up of exceptions.

--Physical inspection.

Completion of the specific procedures included in all work programs should enable the internal auditor to reach conclusions that will satisfy the related audit objectives. Also, such conclusions should be appropriate in view of the work performed. Audit reports that are prepared must be consistent with such conclusions. In addition, such reports should include, when appropriate, recommendations by the internal auditor for any required remedial actions.

Program Effectiveness

The effectiveness of any internal audit program depends on a variety of factors. The adequacy of the audit program is, of course, one of those factors, as is proper planning. To plan properly, the auditor must consider all of the factors previously discussed in this section together with those included in "Examination Planning and Control." A third factor in determining the effectiveness of the internal audit function is the supervision and review of the audit work performed which should be appropriate to the competence of the individuals performing the auditing, and the difficulty of the individual areas of audit interest and their degree of risk.

The examiner should also analyze the reporting process because required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. That means that the auditor must

communicate all findings and recommendations in a clear, concise manner, pinpointing problems and suggesting solutions. It also requires that the auditor

submit reports as soon after completion of the related work as practicable and that the report be routed to those officials who have both the responsibility and authority to implement suggested changes. Prompt and effective management response to the auditor's recommendations is the final measure of the effectiveness of the audit program.

Audit Review

The examiner's review and evaluation of the internal audit function is a key element in determining the scope of examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis. The adequacy and effectiveness of the audit program, however, should be determined separately for each area of examination interest. In most circumstances, the examiner should use the Audit Function Questionnaire to determine if sufficient internal audit procedures are performed in each area of examination interest.

Based on the evaluation of relevant factors, the examiner should conclude whether the work performed by the internal auditors is acceptable, partially acceptable, or not acceptable. Often it is more efficient for the examiner to determine the competence and independence of the internal auditor before addressing the adequacy and effectiveness of the audit program. If, for example, the examiner concludes that the internal auditor possesses neither the competence nor the independence deemed appropriate, there is no choice but to conclude that the audit work performed is not acceptable. Accordingly, a review of such work may not be necessary.

The concept of partial reliance or acceptability applies only to the review and evaluation of the internal audit function. There may be situations in which the examiner detects certain weaknesses in the overall audit function or in the auditing procedures applicable to a specific area that are not of such a magnitude as to lead to a conclusion that the audit function is not acceptable. In such situations, the examiner should conclude that the audit function is partially acceptable. For example, if the internal auditor is independent and has performed the appropriate audit procedures for commercial loans within the past year, but has little experience or training in auditing, the examiner would properly conclude that the audit function was partially acceptable.

The Audit Function Questionnaire is intentionally designed to cover the audit objectives in general terms. The questionnaire is intended to assist examiners in arriving at an overall conclusion for each area of examination interest. Accordingly, it ordinarily would not be necessary or desirable to attempt to match specific steps in the verification program with ones in the internal audit programs because in most instances, a number of different procedures could be performed to accomplish an overall audit objective. An examiner may conclude that the audit function is acceptable in a specific area, but that a significant audit procedure, such as confirmation of account balances, was not performed. In such a situation, the examiner should perform those significant verification procedures not included in the internal auditor's program.

Although the CBI recognizes that the frequency of internal audit procedures should be

based on an evaluation of risk associated with each area of audit interest, reliance on the work of internal auditors requires that the CBI establish general frequency guidelines applicable to most situations. Accordingly, most internal audit procedures are expected to be performed annually. It is recognized that occasionally, the time between the performance of certain audit procedures will exceed 12 months. However, the CBI believes that the elapsed time should ordinarily not exceed 18 months. There may be situations in which the associated risk is considered minimal due to, among other factors, the materiality of the amounts involved, the internal control procedures followed, and the bank's history in a particular area. For example, in many large banks with extensive systems of branches, internal audits of cash on hand at the branches may be scheduled on a rotating basis once every one or two years. Such a program of rotating cash counts frequently is combined with periodic surprise counts of cash by branch officers. In that and analogous situations, the examiner may conclude that sufficient evidence exists to accept the frequency followed by the internal auditor. Such conclusions should be supported by appropriate information in the working papers.

External Audits

External auditors may provide services in the areas of auditing and special studies in addition to directors' examinations. Directors employ external auditors to examine the year-end financial statements of the bank and to render a report based on such examination. Thus, the directors are able to receive outside assurance of the validity of the bank's financial position and results of operations and can include the auditors' report in their annual report to shareholders.

External auditors and consultants also are often engaged to conduct in-depth reviews of the operations of specific departments, such as commercial loans or data processing. Such reviews might focus on operations procedures, personnel requirements or other specific areas of interest. Upon completion of such reviews, the auditors may recommend that the bank, among other things, strengthen controls and/or increase efficiency. Banks often employ external auditors as well as other specialists to assist management in specialized fields, such as taxation and management information systems.

Services provided by external auditors are performed at various times during the year. Financial statements are examined annually and generally commence in the latter part of the year with the report issued shortly after the start of the new year. Other types of examinations or reviews are performed at various dates on an "as required" basis.

The objective of an external audit is different from the objectives of an internal audit or a bank examination. In general, external audits are aimed at enabling the accountant to express an opinion on financial statements. The accountant describes the procedures performed and the related findings. Many of the steps included under examination and verification procedures in this handbook are similar to the procedures performed during an audit.

The employment of external auditors to perform annual audits of a bank's financial statements may:

- Assist banks in establishing strong internal controls, internal audit programs, and management information systems.

- Help banks develop operating policies and methods of operations.

- Provide greater assurance that financial reports to shareholders and the public are accurate and include all necessary disclosures.

- Aid board members in fulfilling their fiduciary responsibilities.

Independent auditors may also assist banks with the preparation and/or review of their official regulatory reports to ensure compliance with the requirements of the CBI that those reports be filed accurately and promptly.

External audits performed in accordance with generally accepted auditing standards and of a sufficient scope to enable the auditor to express an opinion on the bank's (or parent holding company's consolidated) financial statements taken as a whole should provide the greatest benefits.

The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise where internal audit work is not being performed or where such work is deemed to be of limited value (partially acceptable) or no value (unacceptable) to the examiner. In such situations, the work performed by external auditors should be reviewed to determine if it may be relied on in lieu of the examiner performing the necessary verification procedures. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, reports rendered by external auditors often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

Certified Public Accountants

The following paragraphs deal with the standards for competence and independence of CPA's as well as the auditing standards to be followed by them in connection with their audits of financial statements and their reports. CPA's must be independent of those they serve. Traditionally, independence has been defined as the ability to act with integrity and objectivity.

The independence of a CPA will be considered to be impaired if, during the period of his or her professional engagement, the CPA or his or her firm had any direct or material indirect financial interest in the enterprise; or had a loan to or from the enterprise or any officer, director or principal stockholder thereof. This latter proscription does not apply to the following loans from a financial institution when made under normal lending procedures, terms and requirements: (1) loans obtained by a CPA or his or her firm which are not material in relation to the net worth of such borrower, (2) home mortgages, and (3) other secured loans, except loans guaranteed by a CPA's firm which are otherwise unsecured.

In determining whether an accountant is, in fact, independent of a particular bank, the CBI will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that bank or any affiliate thereof.

CPA's also are required to perform their examinations, referred to hereinafter as audits, within the framework of generally accepted auditing standards. Auditing standards, as distinct from auditing procedures, are concerned not only with the auditor's professional qualifications, but also with the judgment exercised in the performance of an audit and with the resulting reports. Generally accepted auditing standards include general standards, field work standards and standards of reporting.

The general standards require that the examination be performed by a person or persons having adequate technical training and proficiency, that an independence in mental attitude be maintained, and that due professional care be exercised in the performance of the audit and the preparation of the report.

CPA's possess basic education in accounting and auditing or equivalent experience. Field work standards include requirements that:

天 The work be adequately planned.

天 Assistants, if any, be properly supervised.

- A proper study and evaluation of existing internal controls be made as a basis for reliance thereon for the determination of audit scope and audit procedures, including the extent of testing.

- Sufficient evidence be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit.

Reporting standards require that the CPA state whether the financial statements are presented in accordance with generally accepted accounting principles and whether such principles have been consistently applied in the current period in relation to the preceding period. In addition, the informative disclosures in the financial statements must be reasonably adequate or the CPA must state otherwise in the report.

The report must contain an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. Any reasons for the CPA being unable to express an overall opinion on the financial statements also must be stated in the report.

Although the reports issued by CPA's at the conclusion of their examinations of financial statements vary, for the purposes of this discussion they have been limited to two general types. The first, commonly referred to as the short-form report, generally consists of two paragraphs; the first or scope paragraph identifies the financial statements examined and describes generally the work performed, and the second paragraph contains an expression of the CPA's opinion. Generally, the following form is used for short-form unqualified opinions:

We have examined the balance sheet of the Bank of Anytown as of December 31, 19XX, and the related statements of income retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the Bank of Anytown as of December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Any modifying language, either in the description of the scope of the auditor's work or in the opinion, should be considered as qualifying the opinion in some manner, except when the auditor's opinion is based in part on the report of another auditor. Departure from the auditor's standard report may be required by the following circumstances:

- The scope of the audit has been restricted by the bank or has been affected by conditions that do not permit the application of auditing procedures considered necessary in the circumstances.

天 Inadequate disclosure or lack of conformity with generally accepted accounting principles affect the financial statements in that they do not fairly present financial conditions, results of operations, or changes in financial position.

天 Accounting principles have not been applied consistently.

天 Unusual uncertainties exist as to the outcome of future events, and their effect on the financial statements cannot be reasonably estimated.

When the exception is material, but not so material as to negate an opinion on the financial statements taken as a whole, a qualified opinion is appropriate. What is sufficiently material is a matter of judgment in the circumstances. If the matter is related to the scope of the procedures or the fairness of presentation of the financial statements, the phrase, "except for" is normally used. The phrase "subject to" is used properly only in situations where an uncertainty exists.

An adverse opinion is issued by the auditor when the matter taken exception to is so pervasive in effect that the financial statements do not present fairly the financial position, results of operations, or change in financial position, and/or are not in conformity with generally accepted accounting principles.

A disclaimer of opinion is issued when the scope of the auditors' examination has been restricted in important respects, either by the bank or by circumstances, or when the financial statements are affected by uncertainties.

In the case of a qualified, adverse or disclaimer of opinion, the auditor should set forth all material reasons for issuing the particular report form. As to limitations of scope, the report would specify any generally accepted auditing procedures which were omitted and the reasons for omission. If the omission had been requested by the bank, that should be specified.

The second general type of report that the examiner should recognize is the long-form report. In its use in the banking industry, this type of report generally includes a more detailed description of the scope of the CPA's examination than is found in the short-form report. The comments on audit scope included in the long-form report should:

> . . . set forth generally the extent of the auditor's review and tests including the inspection; observation; inquiry and confirmation work relating to the various asset and liability accounts, income and expense accounts, memorandum accounts, and other phases of the audit not directly related to the accounting records. The comments should also include any exceptions noted during the audit.

Suggestions for improving the bank's internal controls, accounting procedures, and other matters may be included in the long-form report or may be the subject of a separate letter report. Although the long-form report provides this additional information, the departures from the CPA's standard report that are described in the preceding paragraphs are applicable to long-form reports.

Engagement Letters

It is not uncommon for a bank to require that external auditors submit engagement letters to the bank or its directorate prior to commencing their work. Such letters include among other things, the scope of the audit, the period of time to be covered by the audit, and the reports expected to be rendered. In many cases, the highlights of these matters will be summarized in the body of the letter with greater detail being provided in schedules or appendices to the letter. Procedures may be specific by audit area. That is, the auditor may provide a capsulized description of procedures with regard to cash and due from banks, loans, deposits, etc. In addition, if there are any limitations on the scope of the audit, the letter may specify any auditing procedures which are to be omitted, such as confirmation of loans or deposits, if the auditor is expected to render an opinion on the bank's financial statements.

Audit Review

The examination procedures program for this section contains the detailed steps to be followed by the examiner in conducting a review of CPA's and the work they perform. The following paragraphs discuss certain of the criteria the CBI considered in developing those procedures.

The CBI has concluded, that in view of its objectives regarding the reliance to be placed on work performed by CPA's and in view of the professional and ethical standards of the public accounting professions, that only in unusual situations should the examiner conduct an in-depth review of the competence and independence of the CPA or of the adequacy of the CPA's audit. One situation that the examiner should investigate would be a recent change in CPA's by a bank, particularly if the change was made after an audit was commenced.

It ordinarily will not be necessary to make specific tests to determine independence. However, there may be occasions when the examiner may have sufficient reason to question the independence of a CPA or the quality of his or her work. For example, the examiner may become aware that, during the period of a CPA's professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm:

- Had a direct financial interest in the bank;
- Was connected with the bank in a capacity equivalent to that of a member of management or was a director of the bank;
- Maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records; or,
- Had an unsecured loan from the bank that was considered to be material relative to the net worth of the borrower.

In such instances, and that list is by no means all-inclusive, the CPA would not have complied with professional standards. Accordingly, the examiner should not rely on any work performed by the CPA without a review of the procedures followed in performing the audit. Such a review may require the examiner to request, through the bank, that the CPA make available appropriate working papers. The CPA's working papers should be reviewed in light of the applicable criteria discussed under "Internal Audits" and the minimum procedures outlined in the Audit Function Questionnaire. If the procedures satisfy the examiner's requirements, he or she may rely on the work performed. The examiner may conclude, however, that the circumstances, and their attendant risks, preclude the acceptance of the work performed by the CPA. In such cases, no reliance should be placed on the CPA's examination. The CBI believes that such situations will be rare, and therefore they should be discussed with the CBI management prior to requesting the CPA's working papers or concluding that the CPA's examination is not acceptable. The circumstances, procedures followed, findings, and conclusions should be clearly described in the examiner's working papers.

The examiner should determine the scope of the CPA's examination by reviewing the last report issued by the CPA and, if the audit is in progress or is planned to commence in the near future, any engagement letter to the bank from the CPA should be reviewed. The examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of his or her examination to determine if such entries are normal recurring accruals or if the entries indicate inadequate accounting records. There will be situations where the examiner finds that the CPA was instructed to omit certain procedures that are required by generally accepted auditing standards and that are included in the examiner's verification procedures. In that situation, the examiner should place no reliance on the CPA's examination for the procedures omitted.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations which are covered by one or several verification programs, the examiner may be in a position to rely on the procedures performed by the CPA in all other areas of interest. If the examiner is not able to relate the matters involved to specific verification programs or procedures, no reliance should be placed on the procedures performed by the CPA.

External Audits by Others

There will be situations in which the external auditing is performed by individuals who are not certified public accountants. Examples of others who may perform such an audit include the internal audit group of a related organization, e.g., a bank holding company, or the internal audit department of a correspondent bank. Both of those groups are "external" insofar as the audited bank is concerned. Such auditing may afford the examiner the same reliability as auditing performed by CPA's. The principal differences, as far as the examiner is concerned, are the absence of professional standards of competence and independence and the lack of circumstances requiring

the auditor to maintain the confidence of the public, as well as various regulatory authorities, in his or her role as an independent agent. Accordingly, the general criteria contained in the program External Audits - Non-CPA's is very similar to the criteria for reviewing and evaluating internal audits.

The examiner may believe that specific circumstances exist that would alter the result obtained by following the guidelines discussed above. Accordingly, such circumstances should be discussed with the CBI Bank Supervision Department management at the conclusion of the pre-examination analysis.

EXAMINATION OBJECTIVES

1. To determine whether internal and external audit functions exist.

2. To evaluate the independence of those who provide the internal and external audit functions.

3. To evaluate the competence of those who provide the internal and external audit functions.

4. To determine the procedures performed by the internal and external auditors

5. To determine based upon the above criteria the reliance that can be placed on the procedures performed by internal and external auditors.

EXAMINATION PROCEDURES

This examination program and Audit Function Questionnaire should be used for reviewing the bank's internal and external audits and the audit procedures they encompass. The Audit Function Questionnaire is general and all sections and/or questions will not be applicable to every bank. When completing the questionnaire, the examiner should include a brief comment stating the reason a section or question is not applicable to any specific situation. When multiple locations of a bank are being examined, applicable sections of the questionnaire should be completed for each location.

The questions on audit function should be answered separately for internal and external auditors, as appropriate. For the detailed audit function questions, it is not necessary to answer the specific questions as they relate to external audits performed by a CPA in order to render "short-form" reports of an opinion on a bank's financial statements. If the external auditors were not CPA's or if the work of the CPA's was performed for some other purpose, then the detailed audit function questions should be answered. Prior to answering any specific audit function questions, the examiner should first determine the competence and independence of the auditors. If the examiner believes the auditors to be both competent and independent, he should then determine the acceptability of their work. The Audit Function Questionnaire should be completed only if the examiner determines that the auditors are both competent and independent, and that their work is acceptable or partially acceptable. Based on the answers to the specific audit function questions and the auditor's work, the examiner must then determine which verification procedures he or she considers necessary to perform.

The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination working papers. Comments that exceed the space provided should be cross-referenced and continued on an attachment.

Upon completion of the program, the examiner should be able to formulate a conclusion on the adequacy of audit coverage. Conclusions of weaknesses in the internal audit work being performed at the bank should be summarized for inclusion in the report of examination. Significant recommendations should be discussed with bank management and noted in the questionnaire and in the report of examination. If recommendations are made orally, a memorandum of the discussion should be prepared and included in the working papers.

Internal Auditors

1. Evaluate the competence of the auditor by:

    a. Reviewing the personnel files of those employees designated as internal auditors noting the level of education attained, significant work experience, certification as a Chartered Bank Auditor, Certified Internal

Auditor or Certified Public Accountant, membership in professional associations, etc. In a large internal audit department, the review should include the department manager and a sample of audit supervisors and staff.

b. Discussing with the audit manager and the personnel officer the educational and experience requirements for different audit positions, and the training provided for persons in those positions.

c. Discussing with the selected employees, their program of continuing education and professional development.

d. Discussing supervision of the auditors with the audit manager and, where appropriate, observing such supervision.

2. Based upon those procedures and any others considered appropriate in the circumstances, answer the following questions:

a. Does the internal auditor possess adequate education and training?

a. Does the internal auditor demonstrate a commitment towards continuing education and professional development?

b. Does supervision of auditors appear to be adequate?

3. Determine the extent of board or audit committee supervision of the internal audit function by reviewing briefed board or audit committee minutes and by discussing with audit manager to determine if:

a. The audit program and schedule have been formally approved.

b. Audit reports are monitored to determine if approved programs and schedules are adhered to.

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

d. Active management participates in and/or dominates the directorate's supervision of the internal audit function.

4. Evaluate the independence of the auditor by:

a. Discussing with the audit manager or other bank personnel assigned internal audit duties, whether there are any operational duties assigned to the auditor or any relationships, such as family ties with other bank employees, which are incompatible with the internal audit function (each area of examination interest should be considered separately).

b. Discussing, with the audit manager any restrictions which have been placed on the audit programs and any scheduling or budgetary restraints imposed by management.

c. Tracing the distribution of the internal audit reports to determine if the auditor reports to the board or audit committee or, less desirable, to an officer not connected with the area being reviewed.

d. Reviewing board or committee minutes and operating memoranda relating to discussions of internal audit reports and resultant actions to determine if appropriate and timely action results from the submission of valid comments by the auditor.

5. Evaluate the scope of the auditor's work by:

a. Reviewing the bank's audit program for completeness and compliance with prior board or committee approval.

b. Obtaining copies of the internal audit reports and the supporting working papers.

c. Analyzing the auditor's evaluation of departmental internal controls and comparing it to the evaluation done by NBR examiners.

d. Reviewing the reports and the working papers to determine that they are adequate and prepared in accordance with the audit program.

e. Completing the Audit Function Questionnaire.

6. Based upon the procedures in step 5, and any others considered appropriate in the circumstance, answer the following questions for each area under review:

a. Do the working papers disclose that the procedures and conclusions set forth in the reports are adequately supported by specific, initialed program steps, calculations or other evidence?

b. Is the scope of the procedures adequate?

7. Determine that all significant deficiencies noted in the audit reports have been corrected or determine the reason why corrective action has not been initiated by:

a. Distributing, to each examiner assigned an examination area, a copy of significant audit deficiencies for that area.

b. Requesting that the examiner prepare and return a memorandum regarding the status of any corrective action being taken.

c. Determine the level of reliance to be placed on the auditor's work in each area of examination interest, i.e., acceptable, partially acceptable, not acceptable, or none.

External Auditors - CPA's

1. Obtain copies of the auditors' reports and engagement letter, if any.

2. Read the reports and letter carefully noting any qualifications made by the auditor.

3. Determine the existence of any material weaknesses in internal accounting controls by:

   a. Reading the report of material weaknesses.

   b. Discussing verbal communication with bank management and representatives of the accounting firm.

4. Determine if the CPA appears not to be independent by discussing with appropriate bank officials the relationship, i.e., stockholder, significant unsecured borrower, director of the auditor to the bank. The materiality of any loans to the CPA or his or her firm should be measured in relation to the net worth of the borrower.

5. Determine if the bank has recently changed CPA's, and discuss with appropriate bank management the reasons for such change. Particular attention should be given over disagreements between the auditor and management as to the appropriate accounting principles applicable to specific transactions or matters.

6. Obtain and review any adjusting journal entries suggested by the CPA at the conclusion of his or her examination to determine if such entries are normal recurring accruals or if the entries indicate inadequate accounting records.

7. Complete the applicable portions of the Audit Function Questionnaire.

8. If, in the performance of the above procedures, any adverse information has come to the examiner's attention:

   a. Where the auditor appears not to be independent, discuss the situation with the Bank Supervision Department management.

   b. Where the auditor has omitted a significant procedure, e.g., confirmation of deposits, perform the necessary procedure.

   c. Where the auditor has issued other than an unqualified opinion, determine the reasons for the particular type of opinion issued, and perform the verification procedures for the areas specifically affected.

9. Determine that all significant deficiencies noted in the audit reports have been corrected, or determine the reason why corrective action has not been initiated by:

    a. Distributing, to each examiner assigned an examination area a copy of significant audit deficiencies for that area.

    b. Requesting that the examiner prepare and return a memorandum regarding the status of any corrective action being taken.

    c. Determine the level of reliance to be placed on the auditors' work in each area of examination interest, i.e., acceptable, unacceptable, or none.

External Auditors - Non-CPA's

1. Evaluate the competence of the auditor by:

    a. Arranging, through the bank, to meet with the auditors.

    b. Discussing with the auditors their education and experience, noting the level of education attained, significant banking industry experience, certification as a Chartered Bank Auditor, Certified Internal Auditor, etc.

    c. Discussing with the auditors their commitment to a program of continuing education and professional development.

    d. Discussing with the auditors their procedures for supervising the engagement.

2. Based upon those procedures and any others considered appropriate in the circumstances, answer the following questions:

    a. Do the auditors possess adequate education and training?

    b. Do the auditors demonstrate a commitment to continuing education and professional development?

    c. Is the supervision of the auditors adequate?

3. Evaluate the independence of the auditor by:

    a. Discussing, with knowledgeable officials of the bank, the relationship of the auditors to the bank and to any director, officer, or employee to determine if such relationships compromise the auditor's independence.

    b. Discussing, with knowledgeable officials, whether the auditors have had significant dealings with the bank in the form of stock holdings or borrowings and reviewing the terms of any such dealings.

c. Discussing, with knowledgeable officials, the professional reputation of the auditors.

4. Evaluate the scope of the auditor's work by:

   a. Obtaining and reading copies of the audit reports.

   b. Arranging, through the bank, to review the supporting working papers.

   c. Analyzing the auditor's evaluation of departmental internal controls and comparing it to the evaluation done by NBR examiners.

   d. Completing the applicable portions of the Audit Function Questionnaire.

5. Based upon the procedures in step 4, and any others considered appropriate in the circumstances, answer the following questions for each area under review:

   a. Do the working papers disclose that the procedures and conclusions set forth are adequately supported by specific program steps, calculations, or other evidence.

   b. Is the scope of the procedures adequate?

6. Determine that all significant deficiencies noted in the audit reports have been corrected, or determine the reason why corrective action has not been initiated by:

   a. Distributing, to each examiner assigned an examination area, a copy of significant audit deficiencies for that area.

   b. Requesting that the examiner prepare and return a memorandum regarding the status of any corrective action being taken.

7. Determine the level of reliance to be placed on the auditor's work in each area of examination interest, i.e.. acceptable, unacceptable, or none.

General

1. Review the following items with appropriate bank management, or prepare a memo to other examining personnel for use in reviewing with management:

   a. The adequacy of the Internal audit program.

   b. Instances where the internal audit department has failed to carry out the audit program.

   c. Outstanding internal/external audit report comments.

2. Prepare comments to be included in the report of examination.

3. Prepare a memorandum, and update the work program with any information which will facilitate future examinations.

AUDIT FUNCTION QUESTIONNAIRE

Review reports and the appropriate programs and working papers of the auditors in order to answer the following audit function questions. Where appropriate supporting documentation and pertinent information should be retained or noted under comments.

For the following areas, has the internal or external auditor within the last 18 months:

Cash Accounts

1. Verified cash on hand (verification should have included confirmation of incoming or outgoing cash shipments)?

2. Reviewed cash items for propriety of amount and classification?

3. Verified clearings (verification must have included confirmation procedures) and reviewed all incoming returned items for some period subsequent to the date clearings were verified?

Due From Banks

1. Tested bank reconcilement's including the National Bank of Romania?

2. Received cut-off bank statements as of the examination date and an appropriate date subsequent to the examination date for use in testing bank reconcilement?

3. Reviewed all returned items for an appropriate period subsequent to the examination date?

4. Confirmed due from banks--time accounts with the banks holding the deposits?

Investments

1. Verified investment securities balances (verification must have included physical count of securities located at the bank, and confirmation of bank ownership and control of securities held in custody outside the bank or in transit)?

2. Checked the book and market value of investment securities?

3. Checked the gain and loss of investment securities sold during the period?

4. Reviewed the accrued interest accounts and checked computation of interest income?

5. Ascertained that securities transactions comport with stated portfolio objectives and

   a. Included a review of the securities dealers with whom the bank conducts securities activities?

   b. Included a review of objectionable investment portfolio transactions?

6. Checked for compliance with laws and regulations applicable to those banks engaging in the purchase or sale of securities instruments for their own account or for the account of customers (including furnishing commodity advice to customers)?

Bank Dealer Activities

1. Verified securities balances (verification must have included physical count of securities located at the bank and confirmation of securities held outside the bank or in transit)?

2. Checked the book and market value of trading account securities?

3. Checked the gain and loss on underwriting and trading account transactions?

4. Reviewed the accrued interest accounts and checked computation of interest income?

5. Verified "fails" and "due bills" (verification must have included confirmation procedures)?

6. Verified good faith deposits and cash collateral (verification must have included confirmation procedures)?

7. Reviewed and tested the bank's compliance with applicable laws and regulations?

8. Determined that the compliance review is conducted pursuant to comprehensive written audit policies and procedures?

9. Determined that violations or suspected violations of laws, rules, and regulations are referred to the legal counsel for review and that the results of that review are made a part of the audit report to the board or its committee?

Loans

Commercial

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation including collateral?

3. Tested the pricing of negotiable collateral?

4. Determined that any necessary insurance coverage is adequate and the bank is named as loss payee?

5. Reviewed the accrued interest accounts and tested computation of interest income?

Accounts Receivable Financing

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation including collateral?

3. Determined that any necessary insurance coverage is adequate and the bank is named as loss payee?

4. Reviewed the accrued interest accounts and checked computation of interest income?

Direct Lease Financing

1. Verified leases and related balance sheet accounts (verification must have included confirmation procedures)?

2. Examined leases and other legal documentation?

3. Checked computation of depreciation expense?

4. Checked computation of interest and/or rent income?

5. Checked computation of gain or loss on property sales and disposals and traced sales proceeds to cash receipts records?

6. Determined that any deferred tax liability or asset is accurately reflected?

7. Reviewed insurance coverage and determined that property damage coverage is adequate in relation to book value and that liability insurance is in effect?

Installment

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation including collateral?

3. Determined that any necessary insurance coverage is adequate and the bank is named as loss payee?

4. Verified unearned discount and any accrued interest balances and checked the computation of interest income?

5. Reviewed sales of repossessed collateral and determined the propriety of the entries made to record the sales?

6. Tested rebate amounts for loans which have been prepaid?

Floor Plan

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation?

3. Physically inspected collateral?

4. Determined that any necessary insurance coverage is adequate and the bank is named as loss payee?

5. Reviewed the accrued interest accounts and checked computation of interest income?

Credit Card

1. Verified loan balances (verification must have included confirmation procedures)?

2. Checked the computation of interest income?

Check Credit

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation?

3. Checked computation of interest (and service fee, if applicable) income?

Real Estate

1. Verified loan and escrow account balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and other legal documentation including collateral?

3. Determined that any necessary insurance coverage is adequate and the bank is named as loss payee?

4. Reviewed the accrued interest accounts and checked computation of interest income?

Construction

1. Verified loan balances (verification must have included confirmation procedures)?

2. Examined, or confirmed with outside custodian, notes and legal documentation including collateral?

3. Verified contingency or escrow account balances?

4. Reviewed the accrued interest accounts and checked computation of interest income?

Reserve For Loan and Lease Losses

1. Verified loan balances for loans charged off since their last examination (verification must have included confirmation procedures) and amounts of debit entries to the reserve account?

2. Examined supporting documentation for loans charged off?

3. Reviewed loan recoveries and agreed amounts to credit entries in the reserve account?

Bank Premises and Equipment

1. Examined support for additions, sales and disposals?

2. Reviewed property transactions with "bank affiliated personnel"?

3. Verified property balances?

4. Checked computation of depreciation expense?

5. Checked computation of gain or loss on property sales and disposals and traced sales proceeds to cash receipts records?

6. Determined that any deferred tax liability or asset, that may evolve from the use of different depreciation methods for book and tax purposes, is accurately reflected?

Other Assets

1. Verified other asset balances?

2. Examined support for additions and disposals?

3. Reviewed the computation of any gains or losses on disposals?

4. Reviewed the bank's computation of any amortization?

5. Reviewed inter-office transactions?

6. Reviewed suspense accounts to determine whether all items included were temporary.

Deposits

Demand and Other Transaction Accounts

1. Verified account balances (verification must have included confirmation procedures)?

2. Reviewed closed accounts and determined that they were properly closed?

3. Reviewed account activity in dormant accounts, bank controlled accounts (such as dealers' reserves), employee/officer accounts, and accounts of employees'/officers' business interests?

4. Reviewed overdraft accounts and determined collection potential?

5. Checked computation of service charges and traced postings to appropriate income accounts?

Time Deposit Accounts

1. Verified time deposit account balances (verification must have included confirmation procedures)?

2. Reviewed closed accounts and determined that they were properly closed?

3. Reviewed account activity in dormant accounts, bank controlled accounts, employee/officer accounts, and accounts of employees'/officers' business interests?

4. Reviewed the accrued interest accounts and checked computations of interest expense?

5. Accounted for numerical sequence of pre-numbered certificates of deposit.

Official Checks

1. Reconciled account balances?

2. Determined the validity and completeness of outstanding checks?

3. Examined documentation supporting paid checks?

4. Tested certified checks to customer's collected funds balances.

Borrowed Funds

1. Verified borrowed funds balances (verification must have included confirmation procedures)?

2. Examined supporting legal documents, disclosures, and collateral custody agreements and determined compliance with applicable laws and regulations.

3. Reviewed minutes of the stockholders' and board of directors' meetings for approval of all borrowing requiring such approval?

4. Verified changes in capital notes outstanding?

5. Reviewed the accrued interest accounts and checked computation of interest expense?

Other Liabilities

1. Verified balances of "other liability" accounts (verification procedures must include tests for unrecorded liabilities as of a given date)?

2. Reviewed the operation and use of the "inter-office" account?

3. Reviewed suspense accounts to determine all items cleared on a timely basis?

Capital Accounts and Dividends

Capital Stock

1. If a bank acts as its own transfer agent and/or registrar, accounted for all stock certificates, (issued and unissued) and reconciled par value of outstanding shares to appropriate general ledger control accounts?

2. If bank has an outside transfer agent and/or registrar, confirmed shares issued and activity since previous examination?

3. Reviewed capital changes since previous examination?

Dividends

1. Checked the computation of dividends paid and/or accrued?

2. Reviewed minutes of the board of directors' meetings to determine propriety of dividend payments and accruals?

Consigned Items and Other Non-Ledger Control Accounts

Safe Deposit Boxes

1. Tested rental income?

2. Checked vault entry records for signature(s) of authorized persons?

3. Tested reconcilement's of control records?

Safekeeping/Custodial Accounts

1. Examined or confirmed with outside custodian safekeeping/custodial items?

2. Tested completeness of safekeeping/custodial items and records by examining supporting documentation or by confirming with customers?

3. Tested closed safekeeping/custodial accounts?

4. Tested safekeeping/custodial fee income?

Collection Items

1. Tested collection items by examining supporting documentation, subsequent receipt of payments, disbursement to customers of funds collected, or by confirming with customers?

2. Tested collection fee income?

Consigned Items

1. Reconciled physical count of unissued and voided items on hand to memorandum controls?

2. Confirmed with consignor the inventory on hand at the bank?

3. Tested income from sale of consigned items?

Income and Expenses

1. Tested income and expenses by examining supporting documentation for authenticity and proper approval?

2. Tested accruals by either recomputing amounts or examining documents supporting such accruals?

Related Organizations

1. Reviewed and tested the investment in and the transactions with related organizations?

2. Determined that investments, advances, or transactions with affiliates are consistent with covenants of debt or other instruments as approved by the board of directors or bank management?

"Outside" Service Centers

1. Performed periodic audit procedures for significant automated applications to determine that work flow is processed accurately and in conformity with operating manuals?

2. Controlled or periodically reviewed dormant accounts?

3. Reviewed unposted items?

Funds Transfer Activities

1. Reviewed the wire transfer function for segregation of duties involving receipt, processing, settlement, accounting, and reconciling?

2. Tested staff compliance with credit and personnel procedures, operating instructions, and internal controls?

3. Reviewed intra-day and overnight overdrafts resulting from fails or intentional extensions of credit?

Branches

1. Has the internal or external auditor performed appropriate audit procedures in the branches during the last 18 months which are at least as comprehensive as those listed in the applicable areas above?

INTRODUCTION

This section sets forth the principal aspects of effective internal control and discusses some pertinent points relative to the internal control questionnaires (ICQs). To the extent that audit records can be relied on, they should be used to complete the ICQs implemented during the examination. In most cases, only those questions not fully supported by audit records would require the examiner to perform a detailed review of the area in question.

Effective internal control is a foundation for the safe and sound operation of a financial institution. The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control achieves the following objectives:

- Efficient and effective operations, including safeguarding of assets;
- Reliable financial reporting; and
- Compliance with applicable laws and regulations.

Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management and other personnel, is essential to achieving the internal control objectives.

Objectives of Internal Control

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control:

- Existence of procedures – Existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This attention can be accomplished through inquiry, observation, testing, or a combination thereof.
- Competent performance – For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so

substantially to perform their duties that a serious question is raised concerning their abilities.

- Independent performance – If employees who have access to assets also have access to the related accounting records or perform related review operations (or immediately supervise the activities of other employees who maintain the records or perform the review operations), they may be able to both perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities.

  In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which that individual would respond in a given situation. Fox example, an individual may be the sole check signer and an assistant may prepare monthly bank reconcilement. If the assistant appears to be a competent person, it may seem that an independent reconcilement would be performed and anything amiss would be reported. Such judgments are potentially erroneous. There exist no established tests by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

Procedures for Completing ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

To reach conclusions concerning a specific section of an ICQ, the examiner should document and review the bank's operating systems and procedures by consulting all available sources of information and discussing them with appropriate bank personnel. Sources of information might include organization charts, procedural manuals, operating instructions, job specifications, directives to employees, and other similar sources of information. Also, the examiner should not overlook potential sources such as job descriptions, flow charts, and other documentation contained in internal audit workpapers.

A primary objective in the review of the system is to efficiently reach a conclusion about the overall adequacy of existing controls. Any existing source of information

that will enable the examiner to quickly gain an understanding of the procedures in effect should be used in order to minimize the time required to formulate the conclusions. The review should be documented in an organized manner through the use of narrative descriptions, flow charts or other diagrams. If a system is properly documented, the documentation will provide a ready reference for any examiner performing work in the area, and it often may be carried forward for future examinations, which will save time.

Although narrative descriptions can often provide an adequate explanation of systems of internal control, especially in less complex situations, they may have certain drawbacks, such as:

- They may be cumbersome and too lengthy,
- They may be unclear or poorly written,
- Related points may be difficult to integrate, and
- Annual changes may be awkward to record.

To overcome these problems, the examiner should consider using flow charts, which reduce narrative descriptions to a picture. Flow charts often reduce a complex situation to an easily understandable sequence of interrelated steps.

In obtaining and substantiating the answers to the questions contained in the ICQ, the examiner should develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to:

- Become familiar with the ICQ,
- Review related internal-audit procedures, reports, and responses,
- Review any written documentation of a bank's system of controls,
- Find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals, and
- Answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

An effective way to begin an on-site review of internal control is to identify the various key functions applicable to the area under review. For each position identified, the following questions should be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or an irregularity is perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within an organization may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. The examiner should be primarily concerned with those positions that have the ability to influence the records and that have access to assets. Once those positions have been identified, the examiners must exercise their professional knowledge of bank operations to visualize the possibilities open to any person holding a particular position. The question is not whether the individual is honest, but rather whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

The evaluation of internal control should include consideration of other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal part of the bank's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small banks, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by non-management personnel unlikely, even if disbursements are otherwise under the control of only one person.

When reviewing internal controls, an essential part of the examination is being alert to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert exists when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Also, offices staffed by members of the same family, branches completely dominated by a strong personality, or departments in which supervisors rely unduly on their assistants require special alertness on the part of the examiner. Those circumstances and other similar ones should be considered in preparing the ICQ. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. Circumstances that may affect answers to the basic questions should be noted along with conclusions concerning their effect on the examination.

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) testing. However, certain questions are marked with an asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ. The examiner should be alert for deviations by bank personnel from established policies, practices, and procedures. This applies not only to questions marked with an asterisk but also to every question in the ICQ. Examples of such deviations include situations

when (1) instructions and directives are frequently not revised to reflect current practices, (2) employees find shortcuts for performing their tasks, (3) changes in organization and activities may influence operating procedures in unexpected ways, or (4) employees' duties may be rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures, thus giving the examiner an inadequate basis for evaluating internal control.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed here seem inapplicable. Care should be taken to resist drawing this conclusion. This discussion of internal control and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and records. Those with access may include computer operators, programmers, and their supervisors and other related personnel.

The final question in each section of the ICQ requires a composite evaluation of existing internal controls in the applicable area of the bank. The examiner should base that evaluation on answers to the preceding questions within the section, the review and observation of the systems and controls within the bank, and discussion with appropriate bank personnel. The composite evaluation does, however, require some degree of subjective judgment. The examiner should use all information available to formulate an overall evaluation, fully realizing that a high degree of professional judgment is required.

Applying the ICQ to Different Situations

The ICQs are general enough to apply to a wide range of systems, so not all sections or questions will apply to every situation, depending on factors such as bank size, complexity and type of operations, and organizational structure. When completing the ICQs, the examiner should include a brief comment stating the reason a section or question is not applicable to the specific situation.

For large banking institutions or when multiple locations of a bank are being examined, it may be necessary to design supplements to the ICQs to adequately review all phases of the bank's operations and related internal controls. Because certain functions described in this manual may be performed by several departments in some banks, it also may be necessary to redesign a particular section of the ICQ so that each department receives appropriate consideration. Conversely, functions described in several different sections of this handbook may be performed in a single department in smaller banks. If the ICQ is adapted to fit a specific situation, care should be taken to ensure that its scope and intent are not modified. That requires professional judgment in interpreting and expanding the generalized material. Any such modifications should be completely documented and filed in the workpapers.

Introduction

Every bank maintains a certain amount of Iraqi Dinars currency and some may have foreign currency on hand. To avoid having excess non-earning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers and the availability of replenishment monies, with a reasonable allowance made for unusual demands.

Foreign currency may not be included in cash positions for management purposes when the amounts are not significant. However, the coin and currency of other countries are foreign currency assets, as are loans or nostro accounts, and should be included in the foreign-currency positions.

CLEARINGS

Clearings are checks, drafts, notes, and other items that a bank has cashed or received for deposit that are drawn on other local banks and cleared directly with them. These items can usually be exchanged more efficiently among local banks than through correspondent banks or the payment system. Communities with two or more banks may organize clearinghouse associations, with adopted rules governing members in the exchange of checks. Clearinghouse associations may then extend their check-exchange arrangements to other nearby cities and towns. In most banks, clearings will be found in the department responsible for processing checks.

Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. Most banks have now combined these two functions. Proof and transit may be performed by any combination of tellers or proof clerks, a separate proof and transit department, a check-processing department, an out-clearing department, or some other department. The functions may be centralized or decentralized, manual or automated, depending on the size of the bank and the volume of transactions. The volume of clearings may be so great that the bank's proof operations are conducted after time deadlines for transaction posting or courier delivery. In these cases, daily clearings customarily are determined as of a specific cutoff time. Checks processed to that time are carried in one day's totals, and checks processed after that time are carried in the following day's totals. However, no matter who performs the function or how large the bank, the objectives of a proof and transit system are the same:

- To forward items for collection so that funds are available as soon as possible;
- To distribute all incoming checks and deposits to their destinations;
- To establish whether deposit totals balance with the totals shown on deposit tickets;

- To prove the totals of general ledger entries and other transactions;
- To collect data for computing the individual customer's service charges and determining the availability of the customer's funds;
- To accomplish the assigned functions at the lowest possible cost.

CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash upon presentation. A separate control of all cash items is usually maintained on the bank's general ledger and, if applicable, on the international division general ledger. The ledger is supported by a subsidiary record of individual amounts and other pertinent data. Cash items and the related records are usually in the custody of one employee at each banking office. In their normal daily operations, banks have an internal charge, on the general ledger, to total demand deposits not charged to individual accounts because of insufficient funds, computer misreads, or other problems. Commonly known as return items or rejected or un-posted debits, these items may consist of checks received in the ordinary course of business, loan-payment debits, and other debit memos. In some banks, return items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled ''bookkeepers' return items.'' Other banks do not use a separate asset account; instead, the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank processes items for posting or returns the checks to their source.

Since bookkeepers' return items are usually processed and posted to an individual account or returned to their source on the next business day, the balance of the bookkeepers' return items account should represent the total of only one day's returned items.

When data processing systems are used, the common practice is to post all properly encoded debit items, regardless of whether an overdraft is created. The resulting preliminary overdraft list, together with the items charged, is subsequently reviewed by bank employees, and unapproved items are reversed and separated as bookkeepers' return items. The total of the resulting final overdraft list becomes the final overdraft figure shown on the general ledger.

Several types of cash items should be considered ''cash items not in the process of collection'' and shown in an appropriate ''other assets'' account. Some examples are (1) items that are payable upon presentation but which the bank has elected to accumulate and periodically forward to the payer; (2) items that are not immediately payable in cash upon presentation; and (3) items that were not paid when presented and require further collection effort.

In addition to those items carried in the separate ''cash items'' account on the general

ledger, most banks will have several sources of internal float in which irregular cash items can be concealed. Such items include any memoranda slips; checks drawn on the bank; checks returned by other banks; checks of directors, officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations, or uncollectible accounts.

Examination Objectives

1. To determine if the policies, practices, procedures and internal controls regarding "cash accounts" are adequate.

2. To determine if bank officers and employees are operating in conformance with the established guidelines.

3. To determine the scope and adequacy of the audit function.

4. To determine compliance with laws and regulations.

5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Examination Procedures

1. If selected for implementation, complete or update the cash accounts section of the internal control questionnaire.

2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to that area of examination, and determine if appropriate corrections have been made.

4. Scan the general ledger cash accounts for any unusual items or abnormal fluctuations. Investigate any such items and document any apparent noncompliance with policies, practices and procedures for later review with appropriate management personnel.

5. Obtain teller settlement sheet recap or similar document as of the examination date and agree to the general ledger. Scan for reasonableness and conformity to bank policy.

6. Obtain detailed listings of cash items, including any bank items which are carried in the general ledger balances and scan for propriety and conformity to bank policy.

7. Determine, by discreet corroborative inquiry of responsible bank officials and review documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have been properly reported to the Board of Directors.

8. Review foreign currency control ledgers and dinar book value equivalents for the following:

    a. Accuracy of calculations and booking procedures;
    b. Unusual fluctuations;
    c. Concentrations;
    d. Unusual items.

9. Review foreign exchange revaluation calculations and procedures.

10. Review the following items with appropriate management personnel (or prepare a memo to other examining personnel for their use in reviewing with management):

    a. Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures;
    b. Uncorrected audit deficiencies
    c. Violations of law;
    d. Inaccurate booking of Iraqi dinar book value equivalents for foreign currencies;
    e. Inaccurate revaluation calculations and procedures performed by cash account operations staff.

11. Prepare comments on deficiencies or violations of law noted above for inclusion in the examination report.

12. Update the workpapers with any information that will facilitate future examinations.

Internal Control Questionnaire

Review the bank's internal control policies, practices and procedures for cash accounts. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

CASH ON HAND

1. *Do all tellers, including relief tellers, have sole access to their own cash supply, and are all spare keys kept under dual control?

2. *Do tellers have their own vault cubicle or controlled cash drawer in which to store their cash supply?

3. When a teller is leaving for vacation or for any other extended period of time, is that teller's total cash supply counted?

4. Is each teller's cash verified periodically on a surprise basis by an officer or other designated official (if so, is a record of such count retained)?

5. *Are cash drawers or teller cages provided with locking devices to protect the cash during periods of the teller's absence?

6. Is a specified limit in effect for each teller's cash?

7. *Is each teller's cash checked daily to an independent control from the proof or accounting control department?

8. Are teller differences cleared daily?

9. Is an individual, cumulative over and short record maintained for all persons handling cash, and is the record reviewed by management?

10. Does the teller prepare and sign a daily proof sheet detailing currency, coin and cash items?

11. *Are large teller differences required to be reported to a responsible official for clearance?

12. Is there a policy against allowing teller "kitties"?

13. *Are teller transactions identified through use of a teller stamp?

14. *Are teller transfers made by tickets or blotter entries which are verified and initialed by both tellers?

15. Are maximum amounts established for tellers' cashing checks or allowing withdrawal from time deposit accounts without officer approval?

16. Does the currency at each location include a supply of bait money?

17. Are tellers provided with operational guidelines on check-cashing procedures and dollar limits?

18. Is a record maintained showing amounts and denominations of reserve cash?

19. *Is reserve cash under dual custody?

20. *Are currency shipments –

    a. Prepared and sent under dual control and
    b. Received and counted under dual control?

21. *If the bank uses teller machines –

    a. Is the master key controlled by someone independent of the teller function,
    b. Is the daily proof performed by someone other than the teller, and
    c. Are keys removed by the teller during any absence?

22. *Is dual control maintained over mail deposits?

23. Is the night depository box under a dual lock system?

24. Is the withdrawal of night deposits made under dual control?

25. Regarding night depository transactions –

    a. Are written contracts in effect;
    b. Are customers provided with lockable bags; and
    c. Are the following procedures completed with two employees present:

        i. Opening of the banks,
        ii. Initial recording of bag numbers, envelope numbers, and depositors' names in the register,
        iii. Counting and verification of the contents.

26. *Regarding vault control –

    a. Is a register maintained which is signed by the individuals opening and closing the vault;
    b. Are time-clock settings checked by a second officer;
    c. Is the vault under dual control; and
    d. Are combinations changed periodically and every time there is a change in custodianship?

27. Are tellers prohibited from processing their own checks?

28. *Are tellers required to clear all checks from their funds daily?

29. *Are tellers prevented from having access to accounting department records?

30. *Are teller duties restricted to teller operations?

CASH DISPENSING MACHINES

31. *Is daily access to the automated teller machine (ATM) made under dual control?

32. *When maintenance is being performed on a machine, with or without cash in it, is a representative of the bank required to be in attendance?

33. *Are combinations and keys to the machines controlled (if so, indicate controls)?

34. Do the machines and the related system have built-in controls that –

    a. Limit the amount of cash and number of times dispensed during a specified period (if so, indicate detail) and

    b. Capture the card if the wrong PIN (personal identification number) is consecutively used?

35. Does the machine automatically shut down after it experiences recurring errors?

36. Is lighting around the machine provided?

37. Does the machine capture cards of other banks or invalid cards?

38. If the machine is operated “off line”, does it have negative file capability for present and future needs, which includes lists of lost, stolen, or other undesirable cards which should be captured?

39. Is use of an ATM by an individual customer in excess of that customer's past history indicated on a "suspicious activity" report to be checked out by management (for example, three uses during past three days as compared with a history of one use per month)?

40. Have safeguards been implemented at the ATM to prevent, during use, the disclosure of a customer's PIN by others observing the PIN pad?

41. Are "fish proof" receptacles provided for customers to dispose of printed receipts, rather than insecure trash cans, etc.?

42. Does a communication interruption between an ATM and the central processing unit trigger the alarm system?

43. Are alarm devices connected to all automated teller machines?

44. For on-line operations, are all messages to and from the central processing unit and the ATM protected from tapping, message insertion, modification of message or surveillance by message encryption (scrambling techniques)?

45. *Are PINs mailed separately from cards?

46. *Are bank personnel who have custody of cards prohibited from also having custody of PINS at any stage (issuance, verification, or re-issuance)?

47. Are magnetic stripe cards encrypted (scrambled) using an adequate algorithm (formula) including a total message control?

48. Are encryption keys under dual control of personnel not associated with operations or card issuance?

49. *Are captured cards under dual control of persons not associated with bank operation card issuance or PIN issuance?

50. *Are blank plastics and magnetic stripe readers under dual control?

51. Are all cards issued with set expiration dates?

52. Are transaction journals provided that enable management to determine every transaction or attempted transaction at the ATM?

CASH ITEMS

53. *Are returned items handled by someone other than the teller who originated the transaction?

54. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?

55. Is a daily report made of all cash items, and is it reviewed and initialed by the bank's operations officer or other designated individual?

56. Is there a policy requiring that all cash items uncollected for a period of 30 days be charged off?

57. Do the bank's present procedures forbid the holding of overdraft checks in the cash item account?

58. Are all cash items reviewed at least monthly at an appropriate level of management?

59. *Are cash items recommended for charge-off reviewed and approved by the board of directors, a designated committee thereof, or an officer with no operational responsibilities?

PROOF AND TRANSIT

60. Are individuals working in the proof and transit department precluded from working in other departments of the bank?

61. Is the handling of cash letters such that –

    a. They are prepared and sent on a daily basis;
    b. They are photographed before they leave the bank;
    c. Copy of proof or hand-run tape is properly identified and retained;
    d. Records of cash letters sent to correspondent banks are maintained with identification of the subject bank, date, and amount; and
    e. Remittances for cash letters are received by employees independent of those who send out the cash letters?

62. Are all entries to the general ledger either originated or approved by the proof department?

63. Are all entries prepared by the general ledger and/or customer accounts department reviewed by responsible supervisory personnel other than the person preparing the entry?

64. Are errors detected by the proof operator in proving deposits corrected by another employee or designated officer?

65. Are all postings to the general ledger and subsidiary ledgers supported by source doucuments?

66. Are returned items –

    a. *Handled by an independent section of the department or delivered unoped to personnel not responsible for preparing cash letters or handling cash,
    b. Reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis,
    c. *Scrutinized for employee items, and
    d. Reviewed for large or repeat items?

67. Are holdover items –

    a. Appropriately identified in the general ledger,
    b. *Handled by an independent section of the department, and
    c. Reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?

68. Does the proof and transit department maintain a procedures manual describing the key operating procedures and functions within the department?

69. *Are items reported missing from cash letter promptly traced and a copy sent for credit?

70. *Is there a formal system to ensure that work distributed to proof machine operators is formally rotated?

71. Are proof machine operators prohibited from –

    a. Filing checks or deposit slips or
    b. Preparing deposit account statements?

72. Are proof machine operators instructed to report unusually large deposits or withdrawals to a responsible officer (if so, over what dinar amount)?

INTERNATIONAL DIVISION

73. *Are foreign currency control ledgers and dinar book value equivalents posted accurately?

74. *Is each foreign currency revalued at least monthly, and are profit and loss entries passed on to the appropriate income accounts?

75. *Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign currency tellers?

76. *Does the internal auditor periodically review for accuracy revaluation calculations, including the verification of rates used and the resulting general ledger entries?

CONCLUSION

77. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

78. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate). A separate evaluation should be made for each area, i.e., cash on hand, cash items, etc.

Introduction

Banks maintain deposits in other banks to facilitate the transfer of funds. Those bank assets, known as ‘‘due from bank deposits’’ or ‘‘correspondent bank balances’’ are a part of the primary, un-invested funds of every bank. A transfer of funds between banks may result from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, and many other causes.

In addition to deposits kept at the Central Bank of Iraq and with correspondent banks, a bank may maintain interest-bearing time deposits with international banks. Those deposits are a form of investment.

Banks also use other banks to provide certain services that can be performed more economically or efficiently by another facility because of its size or geographic location. These services include processing of cash letters, packaging loan agreements, performing Electronic Data Processing (EDP) services, collecting out-of-area items, providing safekeeping for bank and customer securities, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one way, the receiving bank usually maintains a minimum balance at the providing bank to compensate in full or in part for the services received.

DEPOSITS WITH OTHER DEPOSITORY INSTITUTIONS

Banks should adopt written policies and procedures to address the risk arising from exposure to a correspondent, and to prevent excessive exposure to any individual correspondent. These policies and procedures should take into account the financial condition of a correspondent and the size, form, and maturity of the exposure. A bank should also limit its inter-day credit exposure to an individual correspondent that is not ‘‘adequately capitalized’’.

BALANCES WITH THE CENTRAL BANK OF IRAQ

All banks are required to keep reserves equal to specified percentages of the deposits on their books. These reserves are maintained in the form of vault cash or deposits with the Central Bank of Iraq (CBI). The CBI monitors the deposits of each bank to determine that reserves are kept at required levels. The reserves provide the CBI with a means of controlling the nation’s money supply.

Changes in the level of required reserves affect the availability and cost of credit in the economy. The examiner must determine that the information supplied to the Central Bank of Iraq for computing reserves is accurate.

DUE FROM FOREIGN BANKS

Due from foreign banks-demand, or nostro accounts, are handled in the same manner as due from domestic bank accounts, except that the balances due are generally denominated in foreign currency.

A bank must be prepared to make and receive payments in foreign currencies to meet the needs of its international customers. This can be accomplished by maintaining accounts (nostro balances) with banks in foreign countries in whose currencies receipts and payments are made.

Nostro balances may be compared with an inventory of goods and must be supervised in the same manner. For example, payment to import goods manufactured in France to Iraq can be made through an Iraqi bank's Euro account with another bank in France. Upon payment in France, the Iraqi bank will credit its nostro account with the French bank and charge its Iraqi customer's dinar account for the appropriate amount in dinars. Conversely, exporting Iraqi goods to France results in a debit to the Iraqi bank's French correspondent account. The first transaction results in an outflow of the Iraqi bank's ''inventory'' of Euros, while the second transaction results in an inflow of Euros. The Iraqi bank must maintain adequate balances in its nostro accounts to meet unexpected needs and to avoid overdrawing those accounts for which interest must be paid. However, the bank should not maintain excessive idle nostro balances that do not earn interest, causing a loss of income. The Iraqi bank also runs risks by being either long or short in a particular foreign currency or by maintaining undue gaps. Losses could result if that currency appreciates or depreciates significantly or if the bank must purchase or borrow the currency at a higher rate.

Excessive nostro overages and shortages can be avoided by entering into spot and forward exchange contracts to buy or sell such nostro inventories. However, all foreign-currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity in those accounts may be substantial and the accounts must be properly controlled.

Examination Objectives

1. To determine if the policies, practices, procedures, and internal controls regarding due from banks are adequate.

2. To determine if bank officers and employees are operating in conformance with the established guidelines.

3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.

4. To evaluate the credit quality of banks with whom demand accounts are maintained.

5. To determine the scope and adequacy of the audit coverage.

6. To determine compliance with laws, rulings, and regulations.

7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

Examination Procedures

1. If selected for implementation, complete or update the Due From Banks Internal Control Questionnaire.

2. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal/external auditors.

3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if corrections have been accomplished.

4. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the balance shown on the cut-off statement if one has been obtained.

5. If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.

6. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.

7. Test the bank's calculation of its Central Bank reserve requirement and determine that reports are accurate and complete by:

    a. Performing a limited review of a sample of line items if the bank has effective operating procedures and has an audit program covering the required reports.
    b. Performing a detailed review of all line items if the bank has not established operating procedures or does not have an audit program covering the required reports.

8. Review the maximum deposit balance established for each due from bank account and determine if the maximum balance:

    a. Is established after consideration of compensating balance requirements resulting from commitments or credit lines made available to the bank or its holding company. Coordinate this effort with examiner assigned "Bank-Related Organizations."

b. Appears to be related to loans of executive officers or directors or to loans which have been used to acquire stock control of the bank under examination.

9. Determine the existence of any concentrations of assets with other banks. Include correspondent accounts and time deposits. For concentrations exceeding 25 percent of the bank's capital structure, forward the information to examiners assigned "Concentrations".

Note: Procedures 10 through 20 apply to due from foreign banks – demand (nostro accounts)

10. Obtain or prepare a trail balance (including local currency book values) of due from foreign banks – demand by bank customer and:

    a. Agree or reconcile balances to department controls and the general ledger.
    b. Review reconciling items for reasonableness.

11. Using an appropriate sampling technique, select demand account banks for examination.

12. Prepare credit line sheets to include:

    a. Customer's aggregate due from banks-demand liability in foreign currency amount and local currency equivalent.
    b. Amount of customer's line designated by the bank.
    c. Frequency of recent overdrawn nostro accounts.
    d. Past compliance with customer's line limitation as determined from review of liability ledger records.

13. Obtain the following:

    a. Specific guidelines in the bank policy relating to due from banks-demand.
    b. Current listing of due from foreign banks-demand approved customer lines.
    c. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
    d. Reports furnished to the board of directors.

14. Review the information received and perform the following for:

    a. Miscellaneous debit and credit suspense accounts.

        i. Discuss with management any large or old items.
        ii. Perform additional procedures as deemed appropriate.

b. For each due from foreign bank-demand deposit so identified, transcribe appropriate information to line sheets and forward the information to the examiner assigned Loan Portfolio Management.

c. Loans criticized during the previous examination (due from foreign banks-demand portion):

i. Determine the disposition of the due from foreign banks-demand so criticized by transcribing:

1. Current balance and payment, or
2. Date the deposit was paid and the source of repayment.

15. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any cancelled bank lines.

16. Prepare credit line cards for any due from foreign banks-demand not in the sample which, based on information derived from the above schedules, requires in-depth review.

17. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and loan areas and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.

18. Obtain credit files for all due from foreign banks-demand for whom credit line cards were prepared and complete credit line cards where appropriate. Then analyze the loans.

19. By reviewing appropriate bank records, determine that:

a. Profit or losses resulting from revaluation adjustment on net open positions spot are passed properly to the respective due from bank-demand (nostro) account (usually monthly).

20. Determine compliance with laws, regulations and rulings pertaining to due from foreign banks-demand activities.

21. Forward list of due from banks accounts to examiner assigned to Investment Securities and to Loan Portfolio Management.

22. Consult with the examiner assigned Asset Liability Management and provide the following, if requested: A listing, by maturity and amount, of due from banks-time deposits.

23. Discuss with appropriate officer(s) and prepare in suitable report form of:

a. Cancelled due from foreign banks-demand deposit lines that are unpaid.
b. Violations of laws, regulations and rulings.
c. Internal control exceptions and deficiencies, or noncompliance with written policies, practices and procedures.
d. Any items to be considered for charge-off.
e. Uncorrected audit deficiencies.
f. Due from foreign banks-demand deposits not supported by current and complete financial information.
g. Due from foreign banks-demand deposits on which documentation is deficient.
h. Concentrations.
i. Criticized loans (portions applicable to due from foreign banks-demand deposits.)
j. Due from foreign banks-demand deposits which for any other reason are questionable as to quality and ultimate collection.
k. Other matters regarding condition of the department.

24. Update the workpapers with any information that will facilitate future examinations.

Internal Control Questionnaire

Review the bank's internal controls, policies, practices and procedures for due from bank accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES FOR DUE FROM BANK DOMESTIC AND FOREIGN-DEMAND ACCOUNTS

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for due from bank accounts that:

    a. Provide for periodic review and approval of balances maintained in each such account?
    b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
    c. Establish levels of check-signing authority?
    d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
    e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
    f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
    g. Establish time guidelines for charge-off of old open items/

2. Are the policies for due from bank accounts reviewed at least annually by the board or the board's designee to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

3. Are bank reconcilements prepared promptly upon receipt of the statements?

4. *Are bank statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare bank reconcilements (if so, skip question #5)?

5. *If the answer to question #4 is no, are bank statements and paid drafts or payments handled before reconcilement only by persons who do not also:

    a. Issue drafts or official checks and prepare, add or post the general or subsidiary ledgers?

b. Handle cash and prepare, add or post the general ledger or subsidiary ledgers?

6. *Are bank reconcilements prepared by persons who do not also:

   a. Issue drafts or official checks?
   b. Handle cash?
   c. Prepare general ledger entries?

7. Concerning bank reconcilements:

   a. Are amounts of paid drafts or repayments compared or tested to entries on the ledgers?
   b. Are entries or paid drafts examined or reviewed for any unusual features?
   c. Whenever a delay occurs in the clearance of deposits in transit, outstanding drafts and other reconciling items, are such delays investigated?
   d. Is a record maintained after an item has cleared regarding the follow-up and reason for any delay?
   e. Are follow-up and necessary adjusting entries directed to the department originating or responsible for the entry for correction with subsequent review of the resulting entries by the person responsible for reconcilement?
   f. Is a permanent record of the account reconcilement maintained?
   g. Are records of the account reconcilements safeguarded against alteration?
   h. Are all reconciling items clearly described and dated?
   i. Are details of account reconcilement reviewed and approved by an officer or supervisory employee?
   j. Does the person performing reconcilements sign and date them?
   k. Are reconcilement duties for foreign demand accounts rotated on a formal basis?

DRAFTS

8. Are procedures in effect for the handling of drafts so that:

   a. *All unissued drafts are maintained under dual control?
   b. All drafts are prenumbered?
   c. A printer's certificate is received with each supply of new prenumbered drafts?
   d. A separate series of drafts is used for each bank?
   e. Drafts are never issued payable to cash?
   f. Voided drafts are adequately cancelled to prevent possible reuse?
   g. *A record of issued and voided drafts is maintained?
   h. *Drafts outstanding for an unreasonable period of time (perhaps six months or more) are placed under special controls?
   i. All drafts are signed by an authorized employee?

j. *The employees authorized to sign drafts are prohibited from doing so before a draft is completely filled out?
k. *If a check-signing machine is used, controls are maintained to prevent its unauthorized use?

FOREIGN CASH LETTERS

9. Is the handling of foreign cash letters such that:

   a. They are prepared and sent on a daily basis?
   b. They are copied or photographed prior to leaving the bank?
   c. A copy of proof or hand run tape is properly identified and retained?
   d. Records of foreign cash letters sent to correspondent banks are maintained, identifying the subject bank, date and amount?

FOREIGN RETURN ITEMS

10. Are there procedures for the handling of return items so that:

    a. *They are delivered unopened and reviewed by someone who is not responsible for preparation of cash letters?
    b. All large unusual items or items on which an employee is listed as maker, payee or endorser are reported to an officer?
    c. Items reported missing from cash letters are promptly traced and a copy sent for credit?

FOREIGN EXCHANGE ACTIVITIES

11. *Are persons handling and reconciling due from bank-demand accounts excluded from performing foreign exchange and position clerk functions?

12. *Is there a daily report of settlements made and other receipts and payments of foreign currency affecting the due from foreign bank-demand accounts?

13. *Is each due from foreign bank-demand foreign currency ledger revalued monthly and are appropriate profit or loss entries passed to applicable subsidiary ledgers and the general ledger?

14. *Does an officer not preparing the calculations review revaluations of due from foreign bank-demand ledgers, including the verification of rates used and the resulting general ledger entries?

15. *Are separate dual currency general ledger or individual subsidiary accounts maintained for each due from foreign bank-demand account, indicating the foreign currency balance and a dinar equivalent balance?

16. Do the above ledger or individual subsidiary accounts clearly reflect entry and value dates?

17. Are the above ledger or individual subsidiary accounts balanced to the general ledger on a daily basis?

18. Does foreign exchange management receive a daily trial balance of due from foreign bank-demand customer balances by foreign currency and dinary equivalents?

OTHER

19. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?

20. Are overdrafts of domestic and foreign due from bank accounts properly recorded on the bank's records and promptly reported to the responsible officer?j

21. Are procedures for handling the Central Bank reserve account established so that:

    a. The account is reconciled on a daily basis?
    b. Responsibility is assigned for assuring that the required reserve is maintained?
    c. Figures supplied to the Central Bank of Iraq for use in computing the reserve requirement are reviewed to ensure they do not include asset items ineligible for meeting the reserve requirement, and that all liabilitiy items are properly classified?

22. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.

23. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Introduction

The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as "special mention", while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of "classified". The term classified is subdivided into more specific subcategories ranging from least to most severe: "substandard", "doubtful", and "loss". The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

Assets Classification

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum:

- The overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- The credit history of the borrower;
- The borrower's or principal's character and the key managers reputation
- The purpose of the credit relative to the source of repayment; and
- The types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)
- The mitigation of the risks (Loan agreement, insurance, contract…)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit quality

rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by co-signers, endorsers, or guarantors.

Classification Categories:

Excellent Credits

Excellent Credits is a category specific to CBI. It was created to avoid taking reserves on loans secured by very strong and reliable collateral or guarantees.
This classification concerns loans guaranteed by precious metals (gold and silver), cash deposits on checking and savings accounts, government bonds readily sellable and for an amount representing twice the value of the credit, government guarantees and guarantees form the OECD. This classification does not require any provisions for loan losses.

Standards Loans

A loan shall be classified as "Standard" if it is paying principal and interest in a timely manner and is supported by the sound net worth and paying capability of the borrower. This classification is proper where the borrower is financially strong and has sufficient capital to cushion unforeseen adverse impacts, is within its profit targets and produces cash flows sufficient to satisfy in a timely fashion all liabilities, including the subject asset.

Collateral or hypothec taken for a loan classified as "Standard" shall serve as an additional component of safety but shall nonetheless be properly documented and registered.

In the case of a business loan in addition to the above financial characteristics, the borrower must prove that its business plan is realistic and viable and that its principle products and marketing strategies are stable and competitive.

A "Standard" loan represents normal performance but all banks are nonetheless required to maintain provisions in their reserves for loan losses of 2% of the unpaid principal balance of the loan

Watch/Special Mention Category

A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extension of credit that might be detailed in this category include those in which:

- The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- Questions exist regarding the condition of and/or control over collateral;
- Economic or market conditions may unfavorably affect the obligor in the future;
- A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- Other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower's capacity and willingness to repay the debt. For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank's borrower.
This classification requires loan provisions of 10%

Substandard – extension of credit inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness that jeopardizes the liquidation of the debt. They are weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. The amount of loan loss provisions for this category is 25%

Doubtful – extension of credit containing all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans. Banks must take a 50% loan provision.

Loss – extensions of credit which is considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Banks should not be allowed to

attempt long-term recoveries while the credit remains on the bank's books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an "other asset". Such a determination should be based on tangible facts recorded in the bank's credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer. The loss category requires loan provisions amounting to 100%.

Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit quality category. This situation is commonly referred to as a "split classification" and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on the liquidation value appraisals. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments

Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its modified terms. With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms.

Role of Guarantees

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors. In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit. To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment. Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes –
    - Guarantors who have already partially performed under the guarantee;
    - Guarantors who have other significant investments in the project;
    - Guarantors whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
    - Guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
    - Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.

- Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.

- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

Off-Balance Sheet Items

The principal off-balance sheet credit related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance sheet credit transactions for the purpose of assigning a credit quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount (the amount that must be advanced in the future.

Loan commitments – defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced.

Commercial Letters of Credit – involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for goods. Commercial letters of credit are customarily used to facilitate internation trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction. Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial

letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

Standby Letters of credit – are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed upon time and with the agreed upon quality. For credit analysis purposes, standby letters of credit are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. Standby letters of credit can be divided into two main groups: "financial" and "non-financial". Financial standby letters of credit essentially guarantee repayment of financial instruments and are commonly used to "guarantee" payment on behalf of customers and issuers of commercial paper. Non-financial standby letters of credit are essentially used as bid and performance bonds to "guarantee" completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

Required Loan Write-ups

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up of supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit administration weakness or to formalize certain decisions, document agreements and to clarify action plans for management. For example, bank management may have agred to either collect or charge off a loan classified doubtful by the next financial statement reporting period or to reverse interest accruals and place the loan on non-accrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by department and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodies within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example,

examiners may wish to group classifications into categories of weakness and to use these listings to support loan administration comments without providing a write-up for each classified item. Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit administration policies and practices as they relate to this component of the bank's loan portfolio.

General Guidelines for Write-ups of Special Mention and Classified Extensions of Credit

A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed:

1. A general description of the obligation.
2. Amount of exposure (both outstanding and contingent or indrawn) as follows:
    a. Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
    b. List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is included in the banking law and its associated regulations.
    c. List and identify the obligor's contingent liabilities to the bank under examination.

3. The obligor and the obligor's location and type of business or occupation.
4. Description and value of collateral. The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.
5. Notation if borrower is an insider or a related interest of an insider.

6. Guarantors and a brief description of their ability to act as a source of repayment.
7. Amounts previously classified.
8. Repayment terms and historical performance including prior charge-offs, and current delinquency status (with notation if the credit is currently on non-accrual status).
9. A summary listing of weaknesses resulting in classification or special mention treatment.
10. A reference to any identified deficiencies in the item that will support loan administration or violation comments elsewhere in the report.
11. If management disagrees with the classification, a statement to that effect along with management's rationale.
12. A concise description of any management action taken or planned to address the weakness in the assets.

At the examiner's discretion, other information may be included in loan write-ups. For example, the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed – unqualified, qualified, disclaimer, or adverse – and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason (s) given by the auditor. When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weakness in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable trends. A trend analysis or details of balance sheet, income statement, or cash flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

LOAN LINE SLIP

Name of the Borrower	Address	
Bank Insider (Yes, No)		Name of Examiner
Bank Emphloyee (Yes, No)		**Shareholders and Manager of Borrowing Company**
Type of Relationship		

Balance		Date		Beginning Balance	Principal Repayment		Interest Repayment		Non-Performing Days	Accumulated Interest
Currency	Equivalent	Origination	Maturity		Amount	Date	Amount	Date		

Collateral (date of appraisal, description of property, name of appraiser)

Classification					
Per Bank			Per Examiners		
Class	%	Amount	Class	%	Amount

Purpose of the Loan and Sources of Repayment (Business Plan)

Violations

Laws and Internal Policies

Information From Credit Register

Interest Rate:

Current Loans

Past-due Loans

Loans Previously Received and Repaid by the Borrower or His/Her/Its Related Party

Number of Days Before Maturity

Name of the Borrower _____ Examiner_____

Basis for Classification

Objective Criteria

____Borrower or its related parties have overdue liabilities in the banking system
____Maturity of interest repayment has been extended
____Maturity of principal repayment has been extended
____Accrued interests are past-due
___ Loan has been renewed
____Interests have been capitalized
____Loan is past-due
____Loan is not secured
____Other

Subjective Criteria

____Financial statements are either non-existent or incomplete
____Provision of the loan contradicts the bank's internal policy
____Borrower's business is immature or has a short history
____Loan was provided in cash to legal entity borrower
____Borrower is in a poor financial condition
____Collateral experiences decline of value in the market
____Purpose of the loan is unknown
____Collateral is over-appraised or does not cover the loan
____Collateral documentation is defficient from legal point of view
____Free schedule of repayments has been defined
____Loan did not serve its purpose
___ Other

Item	**Year Ended 01.01.200_**	**Year Ended 01.01.200_**
Assets, including:		
Cash		
Materials		
Fixed Assets		
Short-Term Investments		
Long-Term Investments		
Receivables		
Other Assets		
Liabilities, including:		
Short-Term Liabilities		
Long-Term Liabilities		
Liabilities Against State Budget		
Other Payables		
Equity Capital, including:		
Statutory Capital		
Reserves		
Profit/Loss of Previous Year		
Profit/Loss of Reporting Year		
Net Cash Flow From Operational Activities		
Net Cash Flow From Financial Activities		
Net Cash Flow from Investment Activities		
ROA		
ROE		
Leverage		
Current Assets/Current Liabilities		
Analysis of the borrower's bank account (at least for the last 6 months)		

Introduction

A concentration of credit generally consists of direct or indirect (1) extensions of credit and (2) contingent obligations that, when aggregated, exceed 25 percent of the bank's capital structure (tier 1 capital plus the allowance for loan and lease losses). A concentration exists when the extensions of credit or other obligations possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations. Furthermore, a concentration may include the aggregate of all types of credit to an investment in a particular homogeneous risk grouping. Limitations imposed by the banking regulations were intended to prevent an individual or a relatively small group from borrowing an undue amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. However, lending limits alone are not sufficient to prevent and control concentrations of credit. Policy guidance for risk diversification should be formulated in conformity with both legal and prudent investment restrictions. Before bank management can limit the bank's involvement or perform the necessary review, it must recognize the various types of concentrations and implement systems to retrieve the information necessary to monitor and report concentrations. The Central Bank of Iraq expects management to identify, measure, monitor, and control concentrations.

Types of Concentrations

There are numerous possibilities for determining concentrations within a loan portfolio. In evaluating a potential concentration, it is important to determine the key factors germane to the credits. Concentrations that are commonly identified in a loan portfolio include the following:

Loans to a group of borrowers, perhaps unrelated, predicated on the collateral support afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a listed concern or a closely held enterprise, a concentration may exist in the underlying collateral

- Economic sector concentration exists where the assets of the bank are concentrated in a particular economic sector, such as real estate, agriculture or retail trade. This makes the bank highly vulnerable to changes in relative prices. For example, the fall of commodity prices has significant effects on banks lending to finance commodity trade or production. Some degree of asset diversification, including investment in foreign exchange, will reduce the risk of such concentrations. Banks often derive their profits from being concentrated in market segments. The ability of a bank to cushion itself against excessive risks depends

on its capital adequacy, the quality of its management, and the technical expertise and experience it has in its market niche. The bank must have adequate and effective internal systems for monitoring and controlling risk exposures

- The aggregate amount of interim construction loans that do not have firm, permanent takeout commitments. In the event that permanent financing is not obtainable, the bank will have to continue financing the projects. This longer term financing subjects the bank to additional liquidity and possibly interest-rate risks, as well as to risks associated with the real estate itself.
- Loans to groups of borrowers who handle a product from the same industry. Although the borrowers may appear to be independent from one another, their financial conditions may be affected similarly if a slowdown occurs in their economic sector.
- Concentrations may also occur in banks located in towns that are economically dominated by one or only a few business enterprises. In these situations, banks may extend a substantial amount of credit to these companies and to a large percentage of the companies' employees. If economic or other events cause the enterprise's operations to slow down or stop, heavy unemployment may result – with other job opportunities in the area limited or nonexistent.

In identifying asset concentrations, commercial and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

Identifying Loan Concentrations

The examiner should understand and evaluate the effectiveness of the internal policies, systems and controls that an institution uses to monitor and manage the risk associated with asset concentrations. Every institution should maintain adequate records that may be used to identify asset concentrations. The degree of sophistication of the reporting records will vary by the size of institution. For example, larger institutions may have the automated capability to segregate loans by codes, while smaller institutions may generate asset concentration listings manually. Regardless of the identification system used by the institution, the accuracy of listed concentrations, as well as the appropriateness of concentrations, should be verified during the examination all new and any existing asset concentrations should be reported monthly to the institution's board of directors or other appropriate committee for review.

Asset Concentrations

Article 30 of the present Iraqi Banking Law concerning large exposures defines certain limits of credit concentration. These legal limits may be amended from time to time. Banks have to comply with these regulations, which may be more restrictive in their internal policies.

Institutions with asset concentrations are expected to have in place effective policies, systems, and internal controls to monitor and manage this risk. The bank's board of directors is responsible for establishing appropriate risk parameters and for monitoring exposure, as well as for evaluating the methods used by management to manage and control concentration risk. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of their particular circumstances and market conditions.

The internal lending policy should ensure that management retains a level of diversification within the loan portfolio by establishing minimum and maximum concentration levels for aggregate loans by sector as a percentage of the total loan portfolio. When weaknesses develop in particular sectors, every individual loan extended to that sector is affected. A bank with a moderate or high percentage of the portfolio in a weakening, volatile, or deteriorating sector could be severely affected. The loan policy's established maximum level for acceptable concentrations of loans should not exceed the limitations established under prudential banking standards

The purpose of an institution's policies should be to improve the overall quality of its portfolio. Institutions that have effective internal controls to manage and reduce excessive concentrations over a reasonable period of time need not automatically refuse credit to sound borrowers because of their particular industry or geographic location. Furthermore, a bank may be able to reduce the risks associated with concentrations through the strengthening of individual credits. For example, the bank may be able to obtain additional collateral or guarantees. In the event of deterioration, the bank's position would be improved because the additional collateral or guarantees provide a cushion against losses. When concentration levels have been built up over an extended period, it may take, in some cases several years, to achieve a more balanced and diversified portfolio mix. Given the institution's trade area, lack of economic diversity, or geographic location, reducing the existing concentration in the near term may be impossible. If a concentration does exist, the banking organization should have adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan. Strong credit policies and loan administration standards should provide adequate control for the risks associated with new loans. The institution should also maintain adequate capital to protect the institution while its portfolio is being restructured. For identified asset concentrations, bank management should be aware of not only the particular company's or industry's recent trends, but also its future prospects.

Reducing Concentrations

Excessive concentration of risk exposure to one customer, industry or economic sector, country or activity has been a major cause of bank losses. Historically, banks have failed because of excessive lending to a group of customers, over-exposure to markets such as real estate or trade-goods, or engaging in speculative activities, such as arising from high foreign exchange exposure. Restricting aggregate credit to large borrowers is one counter-measure, which may also have a beneficial effect in making credit available to a broader group of borrowers.

The principle behind guidelines on a prudential limit to concentration of credit is **the diversification of risks**. Since loans generally comprise the bulk of bank assets, risk concentration has mainly been equated with credit concentration; particularly credit extended to a single customer and related interests. This often leads to:

- Lending not at arms length - bank management may lose its objectivity in lending to large borrowers, who may receive credit at below-market or favorable terms, thus denying credit to other efficient or viable projects.

- Workout of large problem loans - when a bank gives an excessive proportion of its funds to finance a single borrower (or a group of affiliated borrowers), their failure could bring down the bank. The bank may be forced to lend to a failing large borrower to keep it alive, by the constant renewal or "ever-greening" of loans, to avoid causing the bank's own insolvency.

The imposition of lending limits is designed to limit exposure of a single bank to a single borrower, related group or geographical or economic sector. Alternatives for reducing concentration

Some alternatives for institutions whose asset concentrations are not likely to be reduced in the near term are described below:

Increased Holdings of Capital – To compensate for the additional risk that may be associated with an asset concentration, a bank may elect to maintain a higher capital ratio than would be required under the risk-based capital guidelines. This additional capital would provide support in the event the concentration adversely affects the organization's financial position.

Increased Allowance for Loan Losses – The banking organization may choose to factor a cushion for loan concentrations into its determination of an adequate allowance for loan losses in determining the minimum level. This cushion would be available to absorb some deterioration in loan concentrations.

The following alternatives, which are not currently applicable to the Iraqi banking system, represent also an important technique to reduce concentrations.

Loan Participations – If a banking institution has a concentration, it may be possible to sell a portion of the loan portfolio in the secondary market to reduce its dependency on an asset group. If the institution is not large enough to participate in the secondary market, an alternative might be to sell loans, without recourse, to a correspondent bank that is also attempting to diversify its loan portfolio.

Government Guarantee Programs – Another possible solution to reduce the risk associated with a loan concentration is to seek government guarantees of originated loans. In some cases, a government agency may be willing to guarantee (or insure) a portion of agricultural or small-business loans, thereby reducing the risk to the originating bank.

Examination Objectives

1. To determine if the policies, practices, procedures, and internal controls regarding concentrations of credit are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To determine the existence of any concentrations of credit.

4. To determine if any concentrations of credit represent a hazard to the soundness of the bank.

5. To determine that concentrations of credit do not violate applicable banking statutes.

6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

Examination Procedures

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the Concentrations of Credits section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.

4. Request the bank's schedules of concentrations that are reported to the board of directors and/or senior management at regular intervals and –

    a. If schedules are not current, update and/or have bank personnel update them as of the examination date, and
    b. Request that other examiners review the schedules for reasonableness relative to information developed in performing the examination procedures for the various departments.

5. If schedules of concentrations are not maintained or if the listing is incomplete, prepare or obtain the following schedules of obligations that exceed 25 percent of the bank's capital structure –

    a. Loans collateralized by a common security;
    b. Loans, contingent liabilities, and/or other obligations to one borrower or a related group of borrowers;
    c. Loans dependent upon a particular crop or herd;
    d. Aggregate loans to major employers in the service area, their employees, and their major suppliers;
    e. Loans within industry groups;
    f. Out-of-normal territory loans;
    g. All construction or development loans without firm takeout commitments.

6. If the schedules were prepared by others, review them for reasonableness relative to information developed in performing the examination procedures for the various loan areas.

7. Obtain a listing of due from bank accounts.

8. Obtain from the examiner assigned "Investment Securities" the schedule of investments and money market instruments that exceed 10 percent of the bank's capital structure.

9. Combine the schedules obtained in steps 4 through 8 and determine concentrations that equal or exceed 25 percent of the bank's capital structure. The remaining procedures apply only to these concentrations.

10. From the schedule of loans collateraled by a common security, eliminate all borrowers for whom the common security can be considered excess collateral, then review –

    a. The trend in market prices and
    b. Current financial information, if appropriate.

11. For loans dependent upon a particular crop or here –

    a. Review the bank's files for information on market conditions, future markets and estimated prices and
    b. Determine any adverse trends that might affect payment of the concentrations.

12. For loans dependent upon major employers –

    a. Review financial and other available information on the company and evaluate its ability to continue as an ongoing entity;
    b. Review excerpts from trade papers or periodicals in bank files to determine that bank management is adequately informed on the business activity of the company; and
    c. Note any adverse trends that might affect the collectibility of the loans in the concentrations.

13. For loans within industry groups –

    a. Review financial and other available information on each industry and evaluate its ability to continue as a viable industry;
    b. Review the bank's files to determine that management is adequately informed on the activities of the industry; and
    c. Determine any adverse trends that might affect the collectibility of the loans included in the concentrations.

14. For due from bank accounts, inquire as to the reasonableness of the account relative to the activity and services provided.

15. Discuss with management –

    a. The adequacy of written policies regarding concentrations of credit;
    b. The manner in which the bank's officers are operating in conformance with established policies;
    c. Concentrations that will appear in the report of examination, and
    d. Any matter requiring immediate attention.

16. Prepare, in appropriate form, all information regarding concentrations for inclusion in the report of examination. A comment should be made regarding each concentration, particularly regarding the percentage of the bank's capital accounts (total capital) that the total of each concentration represents. Examiners should avoid direct requests for reduction in the concentration unless facts are included that would support this action.

17. Update the workpapers with any information that will facilitate future examinations.

Internal Control Questionnaire

Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

Policies

1. Has a policy been adopted that specifically addresses concentrations of credits?

2. Does the policy include deposits and other financial transactions with financial institutions?

3. Have controls been instituted to monitor the following types of concentrations:

    a. Loans and other obligations of one borrower?
    b. Loans predicated on the collateral support afforded by a debt or equity issue of a corporation?
    c. Loans to a company dominant in the local economy, its employees, and major suppliers?
    d. Loans dependent upon one crop or herd?
    e. Loans dependent upon one industry group?
    f. Loans considered out of normal territory?

4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency)?

5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?

6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of –

    a. Participations or
    b. Arrangements with government agencies such as –

        i. Guarantees or
        ii. Lending arrangements?

7. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

Conclusion

8. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.

9. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section will assist the examiner in performing two separate, but interrelated, functions. They are:

- The evaluation of the depth and scope of formalized policies and procedures used by the bank to manage and control its loan portfolio.

- The preparation of an overview of the entire lending operation by consolidating the results of the examination programs performed in the specific lending departments.

To supervise banks effectively and efficiently, specific loan review objectives should be established based on the overall supervisory strategy for each bank. Credit reviews should be tailored to meet established objectives for each bank.

Examination of the Lending Function

This section establishes a procedural format for bringing together the results of the entire loan examination and provides the examiner with a method of arriving at an overall evaluation for the entire loan portfolio. Historically, examination results have identified problems in the loan area through a detailed review of credits and credit documentation. That is still a valid function. However, contrary to the traditional approach, a review of individual credits may not need to be performed each time the lending area is examined. Objectives consistent with the overall supervisory strategy for the bank should be established to include one or more of the following:

- Quantifying asset quality.
- Evaluating the adequacy of credit administration practices.
- Evaluating the accuracy and adequacy of the bank's internal loan review system.
- Determining compliance with laws, rules, and regulations.
- Following up on management commitments.

The most appropriate credit review objective, or combination of objectives, for a particular bank depends on the overall supervisory goal for that bank. Similarly, the loan selection technique and analysis procedures will depend on the credit review objective.

Asset Quality Review

This form of credit review should be performed when consistent with the supervisory objective. Factors that indicate when an asset quality review should be performed include:

- downturn in the economic environment;
- deterioration in asset quality indicators (past due, non-accruals);
- lack of confidence in the credit administration process;
- changes in lending personnel or philosophy; or
- an unacceptable internal loan review system.

Notwithstanding the above, a full asset quality credit review would typically be performed for new banks entering the Special Supervision program and for banks near insolvency.

Credit Administration Reviews

The foundation of the supervisory process is risk based supervision. Risk based supervision requires a thorough knowledge of the bank's policies, procedures, practices, and controls. Examiners must be able to evaluate the effectiveness of loan-related systems in order to identify potential asset quality problems before they become real ones. Thriving local economies can mask serious lending and internal loan review deficiencies at banks; but when the economy slows down, credit quality problems will surface.

The credit administration function encompasses:

- 天 policy development and implementation,
- 天 loan approval process
- 天 collateral documentation,
- 天 legal documentation
- 天 loan disbursement
- 天 Loans classification
- 天 loan monitoring,
- 天 collection practices (including supervision of workout (problem) loans), and
- 天 Management Information Systems (MIS).

Credit reviews can be designed to test and evaluate all or some of these aspects of loan supervision. A credit review performed with the objective of evaluating the credit administration process involves a systems analysis approach:

- 天 How are things supposed to be done?
- 天 How are they actually being done?
- 天 Are there weaknesses in the system?

Credit administration reviews can be performed to evaluate the lending function at banks with historically low classified levels. These reviews would also be appropriate at problem banks to determine whether poor lending practices have ceased. The scope of such a review can vary greatly depending on the supervisory and credit review objectives.

Internal Loan Review Adequacy Analysis

This type of review is designed to determine the reliability of a bank's loan review or problem loan identification system. A loan review analysis can be utilized to help determine the scope and type of future credit reviews, test the underlying basis of a bank's Reserve for Loan & Lease Losses (RLLL) analysis, or to periodically reaffirm the adequacy of an established internal loan review system. Internal loan review systems that previously have been deemed adequate should be reevaluated at least every three years, or more frequently if changes in personnel, scope, or methodology have occurred.

Loan classification

Classification	Standards	Provisions
Standard /Pass	Non-accrued credits carrying regular risks with good repayment capabilities of the borrower and a strong financial condition	2%
Watch	Accrued credits, which did not pass 90 days on its accrual. Needs follow up for preventing them to develop into a non- performing credit.	10%
Substandard	Credits that are past-due over 90 days but less than 180 days for principal and interest	25%
Doubtful	Credits, which are past-due more than one year from the accrual date and for which collection is considered highly questionable and improbable	50%
Loss	Credits, which are past-due more than one year from their accrual date and considered as uncollectible.	100%

Excellent credit: CBI has added another classification for credits guaranteed by very dependable and liquid collateral. This classification concerns loans guaranteed by precious metals (gold and silver), cash deposits on checking and savings accounts, government bonds readily sellable and for an amount representing twice the value of the credit, government guarantees and guarantees form the OECD . This classification does not require any provisions for loan losses.

Management Commitment Follow-up Reviews

The effectiveness of the CBI's supervisory approach relies on the timely follow-up on identified weaknesses. At each supervisory event, examiners are required to solicit management's commitments and time frames for corrective action, and document these commitments in the Report of Examination (ROE) and CBI bank file. In some instances, management's commitments may be formalized in an administrative action document, i.e. commitment letter, formal agreement, or cease and desist order. For lending related weaknesses, credit reviews which are designed to determine the adequacy and effectiveness of management's corrective action should be performed. The scope of this type of review will vary based upon the nature of the weaknesses and the proposed corrective action.

Target Reviews

This represents credit reviews designed to provide insight into new products, a growth area, or other areas of concern. The objectives of such a review may encompass all of those previously mentioned.

Examination procedures emphasize the correlation of:

- Identified problem credits.
- Past-due loans.
- Credit documentary exceptions.
- Violations of laws, rulings, and regulations.
- Concentrations of credit.
- Evidence of self-dealing loan transactions.
- Collateral documentary exceptions.

with the overall system of policies, practices, procedures, and controls instituted by the bank to prevent such problems. The purpose of that correlation is to determine causes of existing problems and weak situations, which represent a potential for future problems. By focusing attention on loan

policies, practices, procedures, and internal controls, examiners greatly enhance their ability to detect situations that have the potential for future deterioration and that may adversely affect the bank's soundness.

The examiner performing the procedures in this section should make the final decision as to the quality of the entire portfolio, the quality of management review and control, and the scope and adequacy of internal guidelines. A great deal of judgment is necessary in making those decisions because they significantly affect the overall conclusions reached by the examiner-in-charge (EIC). The process of compiling information generated, analyzing it, and formulating conclusions about the causes of existing deficiencies requires considerable thought on the part of the examiner assigned "Loan Portfolio Management." A significant number of value judgments are required. The ultimate conclusions concern the overall general soundness of the lending function as it presently exists and as it is projected for the future. Furthermore, the "Loan Portfolio Management" examiner is expected to discern causes of existing and potential problems, to capsulize the causes and effects, and to present the problems to management and the directorate in such a manner as to obtain positive corrective action.

Bank Lending Policies

The establishment of a written lending policy by the bank provides the foundation for sound loan portfolio management. Throughout this handbook, there is considerable emphasis on the establishment of formal written policies by the board of directors and on their being implemented, administered, and amplified by management. That is, perhaps, most important in the bank's lending function. The board of directors, in discharging its duty to both the depositors and shareholders, must ensure that loans in its portfolios are made with the following three basic objectives of a bank in mind.

- To grant loans on a sound and collectable basis.
- To invest the bank's funds profitably for the benefit of shareholders and the protection of depositors.
- To serve the legitimate credit needs of the community in which the bank is located.

The lending policy should contain a general outline of the scope and allocation of the bank's credit facilities and the manner in which loans are made, serviced, and collected. The policy should be broad in nature and not overly restrictive. The formulation and enforcement of inflexible rules not only stifles initiative, but also may hamper profitability and prevent the bank from serving the community's changing credit needs. A good lending policy will provide for the presentation, to the board or a committee thereof, of loans that officers believe are worthy of consideration but which are not within the purview of existing written guidelines. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in the bank's earning asset mix and within its service area.

In developing the lending policy, consideration must be given to the individual bank's available financial resources, personnel, facilities, and future growth potential. Such guidelines, however, must be void of any discriminatory practices. A determination of who will receive credit, and of what type and at what price, must be made. Other internal factors to be considered include who will grant the credit, in what amount, and what organizational structure will be used to ensure compliance with the bank's guidelines and procedures. As authority is spread throughout the organization, the bank must have efficient systems for monitoring adherence to established guidelines. That can best be accomplished by an internal review and reporting system which adequately informs the directorate and senior management of how policies are being carried out and provides them with information sufficient to evaluate the performance of lower echelon officers and the condition of the loan portfolio.

There are certain components, which generally form the basis for a sound loan policy, but they are not necessarily applicable to every bank.

Lending Personnel -- All bank employees involved in lending are accountable for their actions and shall operate through the chain of command within the lending function.
They are responsible for maintaining the highest standards of performance by adhering to the bank's credit process, policies and procedures.
They must ensure that personal interest does not conflict with their duties and responsibilities and keep up to the bank's ethical standards. They shall act to best serve the interest of the bank while prudently meeting the reasonable needs of the clients. They shall maintain integrity high working standards

Geographic Limits -- A bank's trade area should be clearly delineated, and loan officers and directors should be fully aware of specific geographic limitations for lending purposes. Such a policy avoids loan approval for customers outside the trade area in opposition to primary bank objectives. The bank's primary trade area should be distinguished from any secondary trade area so that emphasis may be properly placed; that is especially important for new banks. Specific restrictions or exceptions should be listed separately

Distribution by Category -- Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, international, or other categories are common. Such policies are beneficial; however, they should have built-in provisions allowing for deviations that are approved by the board or a committee thereof. This allows credit to be distributed in relation to the changing credit needs of the community. During times of heavy loan demand in one category, an inflexible loan distribution policy would cause that category to be slighted in favor of another.

Eligible business: The bank shall define the sectors of the economy to which it wants or does not want to lend. Certain banks may by nature be specialized in a certain sector, real estate, agriculture, but may still limit their activities to specific segment of the industry.

Types of Loans -- The lending policy should state the types of loans, which the bank will make and should set forth guidelines to follow in making specific loans. The decision about the types of loans to be granted should be based on a consideration of the expertise of the lending officers, the deposit structure of the bank, and anticipated credit demands of the community. Sophisticated credits or loans secured by collateral, which require more than normal policing should be avoided unless or until the bank obtains the necessary personnel to properly administer such advances. Types of credits, which have resulted in an abnormal loss to the bank should be controlled or avoided within the framework of stated policy. Real estate and other types of term borrowings should be limited to a given percentage of the bank's stable funds.

Maximum Maturities -- Loans should be granted with realistic repayment plans. Loans Maturities should be related to the anticipated source of repayment, the purpose of loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of the original terms of a loan. The bank should require a cleanup (out-of-debt) period for lines of credit, and that period should be explicitly stated.

Grace Period: Circumstances may dictate that the borrower may need a grace period on principal loan payments in order to provide enough time to commence production and resulting cash generation. Any grace period should be as short as possible and be tied strictly to the actual needs of the business and the activity of the borrower, and not simply to an arbitrary request of the client. In cases where the business is already producing sufficient cash flow to make payments, a grace period is inappropriate.

Loans extensions: Loans should not be extended more than twice, and every time the credits should be downgraded and appropriate loan provisions taken.

Loan Pricing -- Rates on various loan types established by the loan policy must be sufficient to, among other things, cover the costs of the funds loaned, of servicing the loan (including general overhead) and of probable losses while providing for a reasonable margin of profit. Policy makers must know those costs before they establish the rates. Periodic review allows the rates to be adjusted to reflect changes in costs or competitive factors. Rate differentials may be deliberately maintained either to encourage some types of borrowers to seek credit elsewhere or to attract a specific type of borrower. Specific guidelines for other relevant factors, such as compensating balance requirements and fees on commitments, are also germane to pricing policy.

Maximum Ratio of Loan Amount to Appraised Value or Acquisition Costs -- Lending policy should outline where the responsibility for appraisals lies and should define formal, standard appraisal procedures, including procedures for possible reappraisals in the case of renewals or extensions. Acceptable types of appraisals and limits on the local currency amount and type of real or personal property bank personnel are authorized to appraise should be outlined. Circumstances requiring appraisals by qualified independent appraisers also should be described. The ratio of loan amount to appraised value, the method of valuation, and the differences for various types of property should be detailed. The policy also should contain a schedule listing the down payment requirements for financing consumer goods and business equipment.

Maximum Ratio of Loan Amount to the Market Value of Pledged Securities -- In addition to possible legal restrictions, the lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security, i.e., actively traded, over the counter, or closely held. The policy also should assign responsibility and set a frequency for the periodic pricing of the collateral.

Financial Information -- Extension of credit on a safe and sound basis depends on complete and accurate information regarding every detail of the borrower's credit standing. One possible exception is when the loan is predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary not only at the inception of the credit, but also throughout the term of the advance. The lending policy should define the financial statement requirements for businesses and individuals at various borrowing levels and should include requirements for audited, non-audited, fiscal, interim, operating, cash flow, and other statements. It should include external credit checks required at the time of periodic updates. The requirements should be defined in such a manner that any credit data exception in an examination report should be a clear violation of the bank's lending policy.

Limitation on Aggregate Outstanding Loans -- As a guide in limiting the total amount of loans outstanding, relationships to other balance sheet accounts should be established. Controls over the loan portfolio are usually expressed relative to deposits, capital, or total assets. In setting such limitations, various factors, such as the credit demands of the community, the volatility of deposits and the credit risks involved must be considered.

Concentrations of Credit -- The lending policy should strive to develop diversification within the portfolio and to obtain a balance between maximum yield and minimum risk. Concentrations of credit depend heavily on a key factor and when weaknesses develop in that key factor, every individual loan making up the concentration is affected. The directorate should evaluate the additional risk involved in various concentrations and determine those that should be avoided or limited. The lending policy also should require that all

concentrations be reviewed and reported on a frequent basis. For a full discussion of this component, see the section on "Concentrations of Credit".

Loans to related parties/insiders Any loan to the chairman, members of board, VIP persons, a Shareholder, a related party or an insider, must meet the same standards as would apply to any other borrower of the bank with regard to pricing, collateral and repayment and should be done on a normal commercial basis, according to article (31) of Iraqi bank law

Loan Authority -- The lending policy should establish limits for all lending officers. If lending policies are clearly established and enforced, individual officer limitations may be somewhat higher than would normally be expected, based on the officer's experience and tenure with the bank. Lending limits also should be set for group authority, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined.

Collections and Charge-Offs -- The lending policy should define delinquent obligations of all types and should dictate the appropriate reports to be submitted to the board. The reports should include sufficient detail to allow for the determination of the risk factor, loss potential and alternative courses of action. The policy should require a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board for charge-off at a stated period of delinquency.

Other -- The lending policy should be supplemented with other written guidelines for specific departments of the bank. Written policies and procedures approved and enforced in various departments should be referenced in the general lending policy of the bank Before a bank grants credit, its objectives, policies, and practices must be clearly established. Before an examiner examines a loan department, those objectives, policies, and practices should be reviewed to determine if they are reasonable and adequate to properly supervise the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the various loan areas should be examined to determine compliance. That determination is one of the prime examination objectives in each loan department of every bank.

International Lending

Banks engaged in international lending assume several additional risks or problems not associated with domestic lending.

Foreign customers' financial statements may be prepared in either Iraqi Dinar or in the borrower's local currency. Sometimes, the bank may need to reconstruct a borrower's financial statement in local currency equivalents to reflect the borrower's financial strength and weaknesses more accurately.

Since the financial information is not always reliable, the bank's policies should enable it to determine, by other means, the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans, and their financial statements should be reviewed and analyzed. The analysis should include the traditional liquidity ratios and trends. However, those ratios are only indications rather than definitive tests, particularly in the absence of information relating to the quality of the foreign bank's assets and uniform bank supervision.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent, detailed visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, even when provided, are often incomplete or vague. Consequently, there is no substitute for detailed, firsthand information obtained from visits to overseas banks.

Sufficiently current balance of payments, exchange control, and economic, political, and social information should be on file to enable a bank to properly and accurately evaluate the extent of country risk. The lack of such information is as serious a weakness as the lack of financial information on an individual borrower.

Foreign Exchange Risks -- As foreign exchange risks relative to international lending are discussed under "Foreign Exchange," only a few comments are necessary here. Lending policy should include controls that minimize those risks for loan portfolios in one currency funded by borrowings in another. Such activities must be identified and should be limited by the bank if:

- A particular foreign government is expected to impose stringent exchange controls.
- The currencies involved are or will be subject to wide exchange rate fluctuations.
- Political, social, and economic developments are likely to intensify exchange risks.

Multi-currency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower

Documentation and Collateral -- Trade financing often represents a significant amount of an international division's or branch's lending activity. In such financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank's control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation that may be the bank's ultimate support for certain transactions.

There may be significant differences between Iraqi loan agreements and foreign ones. Nevertheless, the bank must insure that its loan agreements with borrowers protect it adequately. Unfortunately, often few or no restrictive covenants are required for international loans because of competition in offshore markets, differing local practices, and the fact that certain international borrowers are considered "prime" companies. Such a practice does not enforce financial discipline on borrowers, and the bank should insist on protective covenants, especially if the borrowers are small or medium-sized obligors. The bank also should insure that loan agreements protect it against adverse changes in foreign tax rules, loan funding problems, and additional withholding and other types of taxes.

The bank must establish policies for taking overseas collateral as security for a loan to assure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government depending on the type of asset. Lending against current assets also requires special care and monitoring. In other countries, borrowers may sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For those and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country's

laws, regulations, and practices, and will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation.

Loan Problems

Failure of the directors to establish a sound lending policy, of management to establish adequate written procedures, and of both to monitor and administer the lending function within established guidelines has resulted in substantial problems for many institutions. Loan problems may be caused by a plethora of errors the bank may have permitted its borrowers to make. Major sources and causes of "problem" credits are:

Self-Dealing -- Self-dealing is involved in a significant number of serious problem bank situations. It is generally found in the form of an over-extension of credit on an unsound basis to directors or large shareholders, or to their interests, who have improperly used their positions as owners to obtain funds in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or services). Officers who hold their positions at the pleasure of the board and shareholders may be subject to influence and, therefore, may not be in a position to evaluate and reject such credits on the same basis as credit requests of other customers. In that situation, management will often vigorously defend the unsound loans or other self-dealing practices perpetrated upon the bank by the owners in a self-dealing situation, both the source and the cause of the problem may originate within the bank.

Over emphasis on Income -- The loan portfolio is usually the most important revenue producing asset. The earnings factor, however, must never be permitted to outweigh that of soundness so that credits that carry unnecessary risks or unsatisfactory repayment terms are granted. Unsound loans usually cost far more than they produce in revenue.

Compromise of Credit Principles -- Bank management, for various reasons, may grant loans carrying undue risks or unsatisfactory terms, with full knowledge of the violation of sound credit principles. The reasons for compromise of basic credit principles may include timidity in dealing with individuals having dominating personalities or influential connections, or there may be friendships or personal conflicts of interest involved. Self-dealing, anxiety for income, and competitive pressures also may lead to a compromise of credit principles.

Incomplete Credit Information -- Character and capability may be determined by many means, but complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial capacity. The lack of supporting credit information is an important cause of "problem" credits. Adequate and comparative financial statements, operating statements, and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing and the intended plan and source of repayment, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the bank's credit files. Proper credit administration and accurate credit appraisal is not possible without such information.

Lack of proper control of loan disbursement – Failure to monitor the disbursement of the loan proceeds may generate credit problems. If the loan is not used for the intended purpose the expected cash generation may not be what was expected from the original credit assessment

Failure To Obtain or Enforce Repayment Agreements -- This constitutes a very important cause of loan trouble. Loans granted without a clear agreement governing repayment are, at the very least, in violation of a fundamental banking principle. Such loans are likely to become problems at some subsequent date. More common, and generally as bad, is the case where the bank has an agreement with the borrower regarding the repayment or progressive liquidation of his loan, but fails to collect the principal payments promptly. A study of loan

losses will show that, in many cases, amortization never equaled the principal payments the borrower agreed to make. It is a sound axiom that good lending and good borrowing both require consistent liquidation.

Complacency -- The following items manifest complacency and should always be guarded against:

- Lack of adequate supervision of old and familiar borrowers.
- Dependence on oral information furnished by borrowers in lieu of reliable financial data.
- Optimistic interpretation of known credit weaknesses based on past survival of recurrent hazards and distress.

Lack of Supervision -- Many loans that are sound at their inception have developed into problems and losses because of lack of effective supervision. Ineffective supervision is almost invariably the result of a lack of knowledge of the borrower's affairs over the lifetime of the loan.

Technical Incompetence -- The technical ability to analyze financial statements and to obtain and evaluate other credit information, thereby protecting the bank in the placement and supervision of loans, is possessed by all able and experienced bankers. When it is not, unwarranted losses are certain to develop. Credit incompetence of management should be discussed promptly with the board of directors. Bad lending decisions due to incompetence of lending authorities

Poor Selection of Risks -- Loan approval should be based on sound underwriting and risk-selection standards. The following is a list of general loan types that may fall within the category of poor selection risks.

- Loans to finance the establishment of businesses, wherein the bank advances on excessive proportion of the required capital relative to the equity investment of the owners.
- Loans based more on the expectation of successfully completing a business transaction than on existing net worth.
- Loans for the speculative purchase of securities or goods.
- Collateral loans carried without adequate margins of security.
- Loans for carrying real estate transactions against narrow equity ownership's.
- Loans made because of other benefits, such as the control of large balances on deposit in the bank and not based on sound net worth or collateral.
- Loans weakened by a bad moral risk.
- Loans resting on the non-marketable stock of a local corporation in conjunction with loans directly to that corporation. The bank is placed in a dual position. It may consider itself forced to finance the corporation far beyond warranted limits to avoid loss on the loans that rest on the stock of the corporation.
- Loans predicated on collateral of problematical liquidation value. A moderate amount of such loans, when recognized by bank management as subject to inherent weakness, may cause few problems. Should they become the rule, however, the bank will be in serious trouble.

Overlending--It is almost as serious, from the standpoint of ultimate losses, to lend too much money to a fundamentally sound financial risk as it is to lend to an unsound risk. Loans

beyond the reasonable capacity of the borrower to repay are unsound. Nowhere is common sense more at a premium than in determining a sound borrower's safe, maximum loan level.

Underlending – Cutting arbitrarily the amount of a loan request may impair on the successful completion of a project and create a cash flow shortfall or delay in generating cash. It may be better to turn down a request than to simply reduce the amount.

Competition -- Competition among banks for size and community influence may result in the compromise of credit principles and the acquisition of unsound loans. The ultimate cost of unsound loans always outweighs temporary gains in growth and influence.

Bank Records and Procedures

The procedures outlined in this section include provisions for limiting the scope of the examination of various lending departments based on an evaluation of the bank's system of internal control, its lending policies, practices, and procedures and its internal loan review program. The examiner must consider both the soundness of policies and practices in the loan area and their application. One means of verifying adherence to policy and procedures is through examiner attendance at loan/discount committee meetings. For example, the examiner must determine the extent to which the bank's practices regarding information compiled about borrowers and maintenance of credit files on borrowers conform with acceptable bank practice. If the bank's policy requires that prospective borrowers submit financial statements at least annually, that all loans be approved by two officers before being made, and that loan files be reviewed on a regular basis by a senior officer of the bank, the examiner might be justified in reducing the extent to which credit files are reviewed in detail. Conversely, if such procedures for handling outstanding loan balances do not exist because of weaknesses in the procedures, lack of adequate personnel, or other reasons, the examiner should extend the review of loan files accordingly.

Nonaccrual of Interest

For uniformity in financial reporting, the CBI has adopted a policy for nonaccrual of interest on delinquent loans. Banks may not accrue interest on any loan when principal or interest are in default for 90 days or more unless the loan is well secured and in the process of collection. Consumer loans and residential real estate loans secured by 1 to 4 family dwellings shall ordinarily not be subject to those guidelines. However, each bank should formulate its own policies to ensure that net income is not being materially overstated.

When a bank places a loan in a nonaccrual status, it must consider how to account for previously accrued but uncollected interest and subsequent payments. Generally accepted accounting principles govern that accounting. One acceptable method, if the interest is considered a loss, is to reverse all previously accrued but uncollected interest against appropriate income and balance sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, the bank charges the reserve for possible loan and lease losses if provisions for possible interest loss were previously made. If accrued interest provisions had not been provided, the entire charge would be expensed against current earnings. A bank is expected to have a well-defined policy governing the charge off of accrued interest receivables.

A nonaccruing loan may be restored to an accruing status when principal and interest is no longer due and unpaid, or it otherwise becomes both well secured and in the process of collection. Prior to restoring a loan to accrual status, management should consider the obligor's prospects for continuing future contractual payments. If reasonable doubt exists, reinstatement may not be appropriate.

Internal Loan Review

Historically, examiners developed loan classifications that were independent of any evaluations made through systems instituted by the bank's management. There is considerable merit, however, in utilizing internal evaluations of loans, particularly in banks that provide for independent credit review by officers. Internal evaluations may provide examiners with information detailing other loans that should be selected for review. Banks should review loans internally for various lending departments. That review may take many forms. It may be a review of a junior officers' loans by a senior lending officer. An independent department staffed by credit analysts performing their own inspection of credit quality enables the early detection of problem loans and notification to appropriate management.

A good internal loan review department will systematically analyze the portfolio. To process the volume of loans efficiently, a minimum size of credit is often established for review. Other processes rely primarily on the identification of credit problems by officers. Other systems exist and must be judged on their merits.

An effective system couples independent review with the identification of loans by officers. The lending officer, because of frequent contact with the borrower, normally identifies potential problems before they are discovered by an outsider. Such a system also ensures that an officer has not become complacent with the relationship and is monitoring the credits. Administrative procedures exist to discourage an officer from withholding a loan from the review process.

An analysis of the loan review includes determining the ultimate use of the review department's findings. The identification of a problem loan normally triggers monitoring with the lending officer stating to the loan review department the nature of corrective action. Independence is critical in maintaining proper control. Credit analysts cannot have control over the loans they are analyzing. Furthermore, the loan review department should report directly to the board of directors, a board committee or a senior officer not involved in lending.

In addition, a good review department must demonstrate competence and employ qualified personnel. Credit analysts must understand the basics of lending and credit quality and stay abreast of developments affecting loans in the bank's portfolio. Their work should be periodically reviewed by supervisors.

Examination procedures are designed to analyze the quality of loan review. Through the use of appropriate sampling, the examiner determines whether the internal loan review process identifies problem loans. The sole attribute being tested is whether a loan is identified as a problem or not. A sampling error occurs when a loan rated as acceptable should have been identified as a problem. Differences between bank classifications and those of the examiner do not constitute an error.

The examiner may accept work performed by a qualified independent loan review. However, he or she will continue to analyze problem credits, unless the internal classifications are comparable to those of the CBI. The examiner will pass non-problem credits as long as there has been no material change since the date of internal review. To make that determination, the examiner compares the information presently on file to that available at the time of the review. Summations of credit quality, if available, are compared to current data. Otherwise, credit information on file at the time of the review is compared to present information. If the internal review is not current, the examiner will analyze the loan.

The examination process should evaluate the loan review process and determine the scope of the review, credit lines selected, and the quality of output. The examiner is expected to investigate problem credits that surface during the examination which should have been uncovered during the bank's loan review process. Furthermore, the examiner is expected to report to executive management and the directorate any deficiencies in loan review and to recommend corrective action.

Bank Evaluation of Country Risk

Country risk encompasses all risks arising from the economic, social, and political conditions in a foreign country and its resultant policies that may affect foreigners' debt and equity investments in that country. More specifically, country risk focuses on the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls, and devaluation. Although the obligor may have the means to repay its indebtedness, the timing of the repayment may be affected by the onset of those developments. Apart from a nation's outright repudiation of external debt, the developments might not result in an uncollectable extension of credit. However, the delay in collection could adversely affect the condition of the lending bank.

Generally, all banks have systems for appraising, monitoring, and controlling their foreign lending activities. Those systems differ from bank to bank in terms of measuring outstanding exposure. For example, not all banks include "in-country" lending by local offices or contingent credits, such as loan commitments, letters of credit, and advances by one bank to its own offices abroad. There is also considerable variation in the degree of support or security required to shift risk from one country to another and in the organizations included in the reporting system, i.e., some banks do not include all domestic offices or majority-owned foreign subsidiaries. Other important differences include:

- The independence of country risk assessments and control from marketing considerations.
- The capability within each bank to make country judgments on the basis of analysis and first-hand knowledge of the country.
- The centralization and formality of procedures.
- The level of review.

Country risk management systems consist of the following important elements:

- Provision for evaluating economic trends, political developments, and the social fabric within countries where bank funds are at risk. Those country studies are derived from economic data supplied by:

  -- The borrower or institutional lenders.
  -- Socio-political commentaries.
  -- On-site reports from bank branches, subsidiaries, or affiliates.
  -- Bank officer visits to the country.

- Definition by the board of directors and senior management of the level of country exposure the bank is willing to assume. That definition normally includes establishing limits on aggregate outstandings, maturities, and categories of risk assets by country to aid operating management in developing and servicing the bank's international loan portfolio.

- The bank's internal reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to:

  -- Accurately assign risk assets to the country of risk.
  -- Assure adherence to the directives of the board.
  -- Provide for at least an annual review of portfolio composition in individual countries.
  -- Establish specific methods for reporting exceptions to established limits.

Rebooking of Charged-off Loans

The CBI has determined that in certain specific cases a bank should be allowed to rebook previously charged-off loans. Rebooking is permitted if the bank can satisfactorily demonstrate that the quality of the charged-off loan has improved significantly. However, a bank which follows the practice of rebooking charged-off loans must have in effect a valid and operational charge-off policy. In addition, rebooking should occur only after the board of directors, or its committee, has approved the rebooked loan, noting the specific improved conditions, which served as the basis for that approval. During examinations, the examiner will use those approvals to evaluate the soundness of the bank's rebooking practices.

Any rebooked charge-offs identified during an examination will be assessed by examiners on a case-by-case basis. The rebooked loan should:

- Meet the criteria used in granting new loans contained in the bank's lending policy.
- Not be granted with a concessionaire interest rate or on other more favorable terms than those which prevail for comparable borrowers in good credit-standing with the bank.
- Not be subject to classification.

If those criteria are not met, examiners should list the subject loan(s) for charge-off.

EXAMINATION OBJECTIVES

1. To determine if policies, practices, procedures and internal controls regarding loan portfolio management are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To determine the scope and adequacy of the audit function.

4. To determine the overall quality of the loan portfolio and how that quality relates to the soundness of the bank.

5. To prepare information regarding the bank's lending function in concise reportable format.

6. To determine compliance with laws, rulings, and regulations.

7. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

EXAMINATION PROCEDURES

1. Complete or update the Loan Portfolio Management section of the Internal Control Questionnaire.

2. Select from among the following examination procedures those steps that are necessary to evaluate the bank's loan portfolio management function. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the selected procedures.

3. Request reports on the following from the bank, by department, as of the examination date, unless otherwise specified:

   a. Past-due loans -- this report should cover:

   天 Single payment notes 30 days or more past maturity

   天 Single payment notes with interest due at specified intervals and demand notes on which interest is due and unpaid for 30 days or more.

   天 Consumer, mortgage, or terms loans, payable in regular installments, on which one installment is due and unpaid for 30 days or more.

   天 Outstandings under canceled advance (overdraft) facilities that are unpaid.

   天 Discounted (purchased) outgoing foreign bills matured and unpaid or advances collateraled by pledged delinquent foreign bills.

   天 Overdrafts resulting from a customer not paying the bank for bankers' acceptances or drafts it paid.

   and should include the following minimum information:

   天 Name of the obligor.

   天 Original amount of the loan.

   天 Outstanding amount of the loan.

   天 Date the loan was made.

   天 Due date.

   天 Terms of the loan.

   天 Number of payments the loan is delinquent.

   天 Date of the borrower's last payment.

   天 Interest billing cycle.

   天 Date up to which interest is paid.

For larger loans, the report should also include:

- Purpose of the loan.
- Any action being taken.

b. Loans in a non-accrual status.

c. Loans on which interest is not being collected in accordance with the terms of the loan.

d. Loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.

e. Loans sold in full since previous examination.

f. Loans considered "problem loans" by management. (This report may be either as of the examination date or as submitted to officer's loan review committee, loan and discount committee or board of directors.)

g. Extensions of credit to employees, officers, directors, principal shareholders, and their interests.

h. Extensions of credit to officers and directors of other banks, and principal shareholders of correspondent banks.

i. Miscellaneous loan debit and credit suspense accounts.

j. Current interest rate structure.

k. Officers' current lending authority.

l. The nature and extent of servicing activities, including:

- The aggregate volume and types of serviced loans.
- The Dollar volume of loans originated from out-of-territory.
- The number of origination's and sales year-to-date compared with the same period in the previous year.
- Fee income from sales and servicing year-to-date compared with the same period in the previous year.

m. Extensions of credit in the form of overnight overdrafts resulting from wire transfer activities.

4. Obtain the following from the examiner reviewing Directors and Management:

a. A copy of written policies covering all lending functions.

b. A statement of whether a standing committee administers the lending function.

c. Copies of reports furnished to the board for its meetings.

d. Lists of directors, executive officers, principal shareholders, and their interests.

e. A summary of the officer borrowing report (debts to own and other banks).

f. A list of rebooked charged-off loans approved by the directors.

5. Obtain a copy of the latest reports furnished to the loan and discount committee.

6. Review the lending policies and updates, thereto, and abstract appropriate excerpts on:

a. Distribution of loans by category.

b. Geographic (including country) limitations.

c. Industrial concentration limitations.

d. Allowable or desirable ratios of loans to other balance sheet accounts.

e. Lending authorities of committees and officers.

f. Any prohibited types of loans.

g. Maximum maturities for various types of loans.

h. Interest rate structure.

i. Minimum down payments for various types of loans.

j. Collateral appraisal policies including:

天 Persons authorized to perform appraisals.

天 Lending values of various types of property.

k. Financial information requirements by types of loans.

l. Guidelines for purchasing paper.

m. Guidelines for loans to major stockholders, directors, officers, or their interests.

n. Guidelines for determining creditworthiness of any institution or customer on whose behalf the bank executes funds transfers.

7. In cases where more than one lending policy exists, determine that policies are internally consistent by reviewing the guidelines previously obtained.

8. Review minutes of the bank's loan and discount committee meetings to obtain:

a. Present members and their attendance record.

b. Scope of work performed.

c. Any information deemed useful in the examination of specific loan categories or other areas of the bank.

9. If deemed beneficial, attend loan and discount committee meetings to verify bank adherence to loan policies and procedures and to determine whether they need improvement or modification. (Performance of this step will also depend upon the scope of the evaluation.)

10. Compare reports furnished to the board, the loan and discount committee, and those received from the bank in step 3, to determine any material differences and that they are transmitted to the board in a timely manner.

11. Obtain a list of directors, officers, principal shareholders, and their interests and determine if any of the directors, officers, principle shareholders and their interests have any loans that are listed in the Past Due schedules obtained in step 3.

12. Perform the following steps for past-due loans:

    a. Compare the following to determine any material inconsistencies:

        天 The past-due loan schedule received in step 3.

        天 Delinquency reports submitted to the board.

        天 List of loans considered "problem" loans by management.

        天 Delinquency lists submitted for regulatory purposes.

    b. Scan the delinquency lists submitted to the board to determine that reports are sufficiently detailed to evaluate risk factors.

    c. Compile current aggregate totals of past-due loans, including overdrafts not paid in 15 days.

    d. If the deposits area is not included in the scope of the current examination, obtain the necessary information on overdrafts by completing examination procedure steps 9.c and 9.d of the deposit accounts program.

13. Perform the following using the loan commitments and contingent liabilities schedule obtained in step 3:

    a. Reconcile appropriate contingencies totals to memorandum ledger controls.

    b. Review reconciling items for reasonableness.

14. Through discussion with departmental management, evaluate the quality of the internal loan review personnel considering:

    a. Level of education.

b. Significant experience.

c. Availability and participation in continuing education programs.

d. Membership in professional organizations.

e. Training methods.

f. Level and quality of supervision.

15. Through discussion with appropriate personnel and the possible use of flowcharts, organizational charts, observation, investigation, etc., analyze the operation of the overall internal loan review process. Determine:

    a. Method of loan selection.

    b. Manner in which the loan is analyzed.

    c. Type of report generated.

    d. Use of results by appropriate bank personnel.

    e. Procedures are in effect to monitor compliance with loan terms and/or loan agreements.

    f. Any possible internal restrictions placed on the review function personnel.

    g. Which internal grade classification qualifies as a credit for the problem loan list.

    h. Procedures required to remove a loan from criticized and/or problem loan list.

16. Develop preliminary conclusion concerning the quality of loan review personnel and the effectiveness of the loan review process.

    天 If loan review personnel are considered qualified, and the loan review process is independent of the lending function, perform steps 21-22.

    天 If independence in the process has not been established, or personnel are not qualified, do not perform steps 23-24.

17. Obtain a list, including credit rating, of all loans reviewed since the last examination and, if available, analytical summations supporting that rating. If steps 23 and 24 are not being performed, review the list and summary evaluations. Based on this review, determine if the bank's evaluations will assist departmental examiners in analyzing their credits.

    a. Using a numerical sampling technique, test the population of loans analyzed by the bank since the last examination to determine if problem loans are being identified. Accomplish that by reviewing internal comments on both passed and criticized loans to determine if appropriate criteria have been considered.

    b. If it has been determined that problem loans are being identified:

        天 Forward a recap by borrower of all loans "passed" by the internal loan review to the examiner-in-charge of the specific loan department examinations.

天 Instruct those examiners to determine which loans "passed" by the internal loan review are contained in their sample.

天 Request that those examiners scan the credit file for all loans identified in previous step to:

-- Determine timeliness by:

- Comparing present credit facility to that in place at the review.
- Comparing present financial information to that used at the review.
- Reviewing any ancillary support for the debt, which was not in place at the review.
- Determining that no material changes have taken place in the borrower's relationship with the bank.
- Decide if the analysis is timely and, if so, do not analyze further.

-- If an individual loan is not considered timely, analyze in the normal manner.

- Request departmental examiners to compute the percentage of loans not timely to the total of the loans identified in step 24b.

18. Based on the results of the above steps, reach a conclusion regarding the scope and adequacy of the loan review function. When internal control questions 17 or 25 have a negative answer, the conclusion results from comparing the examiner's final loan classifications to the findings of the loan review department, keeping in mind the timeliness of the current internal review.

19. Determine general distribution characteristics of the loan portfolio by:

    a. Determining the percentage of total loans in specific classes.

    b. Comparing loan category distributions to policy guidelines.

20. Obtain the results of loan department examinations and perform the following:

    a. Determine any non-adherence to internally established policies, practices, procedures, and controls.

    b. Compare the various department results to determine the extent of non-adherence and if it is system-wide.

    c. Organize internal guideline exceptions in order of relative importance.

    d. Organize violations of law in ascending numerical sequence beginning with violations of the laws followed by violations of the rules.

    e. Review CBI loan classifications and Watch loans to determine:

- 天 Inclusion of all necessary information.
- 天 Substantiation of classification.

f. Determine the aggregate amount of paper criticized in each of the four CBI classifications.

g. Compile a listing of all loans not supported by current and satisfactory credit information.

h. Compile a listing of all loans not supported by complete collateral documentation.

i. Determine the aggregate amount of out-of-area loans.

j. Complete the separate program for "Concentrations of Credit" and determine:

- 天 If all necessary data is included.
- 天 If there is substantiation for including specific items in the report of examination as a concentration.
- 天 If the concentration is undue or unwarranted.

k. Compute the following ratios, and compare to computations from prior examinations:

- 天 Aggregate past-due loans to loans outstanding.
- 天 Aggregate classified loans to gross capital funds.
- 天 Aggregate classified and Watch loans to gross capital funds.
- 天 Aggregate substandard loans plus 50 percent of both doubtful and Watch to adjusted capital funds.
- 天 Aggregate loans not supported by current and satisfactory credit information to gross loans outstanding.
- 天 Aggregate loans not supported by complete collateral documentation to gross loans outstanding.
- 天 Aggregate concentrations of credit to total loans outstanding.

23. Forward the total of loans classified loss to the examiner assigned "Capital Accounts and Dividends".

24. Compare management's list of "problem" loans from step 3 to the listing of CBI classified loans to determine the extent of management knowledge of their own loan problems.

25. Determine, through information previously generated, the causes of existing problems or weaknesses within the system, which present potential for future problems.

26. Determine, through examiners assigned to consumer lending functions, if the bank has adhered to its consumer loan charge-off policy.

27. Forward the following information to the examiner assigned to "Reserve For Loan and Lease Losses":

    a. A listing of loans considered "problem loans" by management.

    b. A listing of CBI classified loans.

    c. A listing of rebooked charged-off loans.

28. Discuss results of the examination of the lending function with senior management of the bank.

29. During discussion with senior management, structure inquiries in such a manner as to:

    a. Gain insight into general management lending philosophy.

    b. Elicit management responses for correction of deficiencies.

30. Write, in appropriate report format, general remarks on:

    a. The scope of the examination of the lending function.

    b. The quality of internal policies, practices, procedures, and controls over the lending functions.

    c. The general level of adherence to internal policies, practices, procedures, and controls.

    d. The scope and adequacy of the internal loan review system.

    e. The quality of the entire loan portfolio.

    f. The quality of management with respect to the lending function.

    g. Causes of existing problems.

    h. Expectations for continued sound lending or correction of existing deficiencies.

    i. Promises made by management for correction of deficiencies.

    j. Loans to insiders and their interests.

31. Compile or prepare all information, in appropriate report format, which provides substantiation for your general remarks.

32. Prepare a memorandum, and update the work program with any information that will facilitate future examinations. Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

INTERNAL CONTROL QUESTIONNAIRE

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that:

    a. Establish suggested guidelines for distribution of loans in commercial, real estate, and installment categories?

    b. Establish geographic (including country) limits for loans?

    c. Establish suggested guidelines for aggregate outstanding loans in relation to other balance sheet categories?

    d. Establish loan authority of committees and individual lending officers?

    e. Define acceptable types of loans?

    f. Establish maximum maturities for various types of loans?

    g. Establish loan pricing?

    h. Establish appraisal (valuation) policy?

    i. Establish minimum financial information required at inception of credit?

    j. Establish limits and guidelines for purchasing paper?

    k. Establish guidelines for loans to bank directors, officers, principal shareholders, and their related interests?

    l. Establish collection procedures?

    m. Define the duties and responsibilities of loan officers and loan committees?

    n. Outline loan portfolio management objectives that acknowledge:

        - Concentrations of credit within specific industries and pertaining to country credits?

        - The need to employ personnel with specialized knowledge and experience?

        - Possible conflicts of interests?

2. Are loan portfolio management policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?

3. Are the following reported to the board of directors or its committees (indicate which) at their regular meetings (at least monthly):

    a. Past-due single payment notes (if so. indicate the minimum days past due for them to be included _____)?

b. Notes on which interest only is past-due (if so, indicate the minimum days past due for them to be included _____)?

c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included _____)?

d. Outstandings under canceled advance (overdraft) facilities that are unpaid (if so, indicate the minimum days past due for them to be included _____)?

e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateraled by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included _____)?

f. Overdrafts resulting from a customer not paying the bank for bankers' acceptances or drafts it paid (if so, indicate minimum days past due for them to be included _____)?

g. Total outstanding loan commitments?

h. Loans requiring special attention?

i. New loans and loan renewals or restructured loans?

4. Are reports submitted to the board or its committees rechecked by a designated individual for possible omissions prior to their submission?

5. Are written applications required for all loans?

6. Does the bank maintain credit files for all borrowers?

7. Does the credit file contain information on:

   a. The purpose of the loan?

   b. The planned repayment schedule?

   c. The disposition of loan proceeds?

8. Does the bank require periodic submission of financial statements by all borrowers whose loans are not fully secured by readily marketable collateral?

9. Is a tickler file maintained to ensure that current financial information is requested and received?

10. Does the bank require submission of audited financial statements based on dinar amount of commitment (if so, state the Lei minimum for requiring _____)?

11. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?

12. Is it required that all loan commitments be in writing?

13. Are lines of credit reviewed and updated at least annually?

14. Are borrowers' outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?

15. Does the bank employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another bank's stock?

16. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:

    a. Rechecks interest, discount, and maturity date computations?

    b. Re-examines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?

    c. Determines that loan approvals are within the limits of the bank's lending authorities?

    d. Determines that notes are being initial-approved by the loan officer?

    e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?

    f. Rechecks liability ledger to determine that new loans have been accurately posted?

    g. Rechecks the preparation of maturity and interest notices?

    h. Examines entries to various general ledger loan controls?

    i. Confirms collateral, loans, and discounts with customers on a test basis?

17. Does the bank have a loan review section or the equivalent?

18. Is the loan review section independent of the lending function?

19. Are the initial results of the loan review process submitted to a person or committee, which is also independent of the lending function?

20. Are all loans exceeding a certain dinar amount selected for review?

21. Do lending officers recommend loans for review?

22. Is a method, other than those detailed in steps 20 or 21, used to select loans for review (if so, provide details)?

23. Are internal reviews conducted at least annually for all lending areas?

24. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?

25. Is the bank's problem loan list periodically updated by the lending officers?

26. Does the bank maintain a list of loans reviewed, indicating the date of the review and the credit rating?

27. Does the loan review section prepare summations to substantiate credit ratings, including pass loans?

28. Are loan review summations maintained in a central location or in appropriate credit files?

29. Evaluation of country risk:

    a. Are significant changes in country conditions and/or levels of exposure brought to the attention of the board of directors or its designated committee promptly?

    b. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?

    c. Are country limits reviewed and updated at least annually?

    d. Prior to granting additional advances or commitments, are outstandings checked to appropriate country limits?

    e. Are lending officers cognizant of specific country limitations?

    f. Are procedures for exceeding country limits clearly defined?

    g. Does the bank have a periodic lending officer call program for countries?

    h. Is there an internal review system, which determines that risk assets outstanding and committed are within the bank's foreign country exposure limits?

    i. Are country risk factors (economic, political, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?

    j. Does the bank's system for maintaining adequate and current country analysis information include:

        - A review of country conditions on a regular basis (state frequency and indicate who performs analyses _____)?

        - A continuing review of current country data obtained from internal and external sources?

        - An analysis of economic, political, social, and other factors affecting country risk?

    k. Does the bank have a formal reporting system on country risk?

    l. Does the bank's country risk evaluation system accurately recognize exposure from country to country on the basis of legally binding guarantees, collateral, or reallocation by office of responsibility?

    m. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?

30. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?

(Note: The 13 preceding questions relate to step 18 of the examination procedures for this section.)

31. Are officers and employees prohibited from holding blank signed notes in anticipation of future borrowings?

32. Are paid and renewed notes canceled and promptly returned to customers?

33. Do loan proceeds disbursed in cash require a customer receipt?

34. Are loan records retained in accordance with record retention policy and legal requirements?

35. Are new notes microfilmed daily?

36. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?

37. Does the bank maintain loan interest rate schedules for various types of loans?

38. Does the bank periodically update interest rate schedules (if so, state normal frequency _____)?

39. Does the bank maintain records in sufficient detail to generate the following information by type of advance:

    a. The cost of funds loaned?

    b. The cost of servicing loans, including overhead?

    c. The cost factor of probable losses?

    d. The programmed profit margin?

40. Has the bank conducted industry studies for those industries in which it is a substantial lender?

Conclusion

41. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

42. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered _____(good, medium, or bad).

Translated from Arabic

Verification procedures

1- Examine the increase in the balance sheet and compare it with the ledger. Include loan commitments and other contingent liabilities.

2- By using the appropriate sampling technique, select some loans from and:
-prepare and send a verification form to the borrowers. This form should include the name of the borrower, loan number, principle and interest, the current balance of the loan, the contingency balance and a brief description of collateral.
- after a reasonable period of time send these requests again.
- in the case there are no answers, or there are discrepancies, follow up and try to resolve all disagreements.
- make sure that the loan documents are complete (date of approval, amount, terms and conditions) and compare with balance sheet.
- if the loan documents are not found, try to get a confirmation from the entity maintaining them.
- verify if the original loan documents had been signed by authorized officers
- compare the collateral description in the commercial loans files match with the description in collateral records.
- check that the assignment documents, authorizing the sale of the securities, mortgage…etc, are in the files.
- check the current value of collateral.
- verify that the "loan to value" is reasonable and is within the bank policies and its regulatory requirements.
- try to identify all collaterals differences
- determine whether the collateral is under the trustee's authority
- make a request to check any collateral held outside the bank
- ensure that each file contain the legal documentation, original guarantees and loan agreements as necessary.
- ensure that the collateral is adequate and that the bank is the beneficiary in case of loses
- review the ledgers relating to disbursements, with the authorizations and make sure they are in line with the terms of the loan agreement.

3- Review the examination reports concerning agricultural loans and:
- ensure that the on-site examination is carried out according to the policy of the bank.
- take into consideration the physical examination of the collateral, the quality of the examinations and the number of examinations. If considered inadequate perform another one.
- If there is a physical examination, compare the results with the records of the bank and investigate the differences, if necessary.

4- Review the accrued interest:
- review and examine the accounting procedures for accrued interest.
- take a quick look at the accrued interest to find if there are any unusual items and follow up by checking the main supporting records.

5- Review the list of problem loans. Check the loan maturities to make sure that the amount recorded does not represent interests.

6- Prepare a table showing the amounts of monthly interest income and the principal balance of the commercial loans, at the end of every month, since the last examination, and:
- compute the revenues.
- examine the important fluctuations / trends.

Commercial loans

Introduction

"Commercial loans" is a term commonly used to designate loans not ordinarily maintained by either the real estate or consumer loans department. In asset distribution, commercial or business loans frequently comprise one of the most important assets of a national bank. They may be secured or unsecured and for short or long term maturities. Such loans include working capital advances, term business loans, accounts receivable lending, overdrafts, discounted bills, lines of credit, agricultural credits, and loans to individuals for business purpose.

Working Capital Loans - Working capital loans or seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal needs and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans are normally unsecured, although recently more working capital loans are being advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing, and service oriented business use short capital loans.

Term Loans - These loans are normally granted for the purpose of acquiring capital assets, such as plant and equipment. Term loans involve greater risk than do short-term advances because of the length of time the credit is outstanding. Because of the greater risk factor, term loans are usually secured and may require amortization. Loan agreements on such credits normally contain restrictive covenants during the life of the loan.

Accounts receivable lending – This type of financing represents a specialized area of commercial lending in which the borrowers assign their interest in accounts receivable to a bank as collateral for a loan. Typical companies who borrow against accounts receivable are businesses, which are growing rapidly and need year-round financing in amounts too large to obtain unsecured loans, non-seasonal companies whose working capital is insufficient to periodically payoff a credit line. (Borrowers can also assign their inventory for this type of financing)

Overdrafts - Overdrafts are created when a deposit customer makes a draft on his bank account in excess of the amount of money he has on deposit. This effectively drives the account balance negative, or into what is said to be an overdraft condition.

The use of overdrafts as a form of financing is not recommended. This is especially true in situations requiring longer-term cash. The problem with using overdrafts as a means of financing is that the repayment and timing of the advances is usually unstructured, and poorly structured loans are difficult to administer. Additionally, a loan that is improperly

structured is more likely to lead to problems regarding repayment unless lending personnel are constantly in contact with the borrower. It is always preferable to have specific and agreed upon loan terms rather than an unstructured advance.

Lines of Credit – It is a type of banking facility commonly used by Iraqi banks. These facilities are granted up to a certain agreed amount for a maximum of one year. It must be fully repaid at maturity. Interest is due monthly and a fee is charged on the unused portion of the line. Lines of credit are secured by guarantees in kind or personal guarantees.

Discounted Bills – Discounted bills are not loans as such, but Iraqi banks include them in their loan portfolio. The bank buys commercial paper from their clients at a discounted price. The maturity of the bills can be over 180 days with a personal guarantee. They are bought with recourse against the drawer.

Loans to Agriculture Sector – In many banks, agricultural loans make up a large percentage of the commercial loans. The nature of the products involved in agricultural loans leads to a slow capital turnover. Generally agricultural loans fall into two general categories. There are seasonal short-term loans, and medium and long maturity term loans.

Seasonal loans are used for items such as grain, fuel, chemicals, labor, and other expenses associated with annual crop production. Repayment is usually dependent on the successful production of a crop or sale of livestock. Longer-term loans are usually for things like machinery, breeder livestock, dairy herds, and perhaps additional purchase and improvement of real estate. . There are two primary risks associated with agricultural lending; the risk of adverse weather conditions and the volatility of commodity prices. These factors, coupled with general economic uncertainty facing any business, make it necessary for banks to ensure that agricultural loans are structured to properly match an individual's existing and projected repayment ability. This means matching the terms of repayment to the timing and size of the borrower's sources of cash flow, based upon reasonable projections for crop yields, prices, expenses, and interest rates.

A bank's agricultural lending policies should address at least the following areas: acquisition of credit information, factors that determine the need for collateral for the loans, acceptable collateral margins, adequate collateral documentation, and appropriate lending terms.

International lending

A bank's international division lends to importers and exporters foreign companies, multinational corporations, foreign banks, and foreign governments – either directly or through state entities. The terms of such lending are consistent with the purpose of the financing.

Short-term working capital loans commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and items on inventory or commodities may be held as collateral.

Medium-term (2-5 years) lending generally represents capital goods financing, shipping loans and various specialized credits. Long –term loans (those exceeding 5 years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state-entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in (an international division) are the same as those for domestic. Loans in international may be direct or discounted. In those instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, is a category of loans unique to international banking. Current account advances are extensions of credit where no instrument of specific indebtedness is used. However, a signed agreement is on file stating the conditions applicable to payment made to the obligor. Other types of international financing treated as loans include own acceptances purchased (discounted), other bank acceptances purchased and discounted trade acceptances.

The same credit risks apply to (international division) loans as to those made in commercial loan departments. To this must be added country risk-the primary additional component that distinguishes an international loan from a domestic loan. Basically, country risk involves the possibility of a loan loss or a "locked-in" situation for the bank because of adverse political , economic and social developments , expropriation ,the freezing of assets ,balance of payments problems, imposition of exchange controls , foreign exchange rate fluctuations, devaluations, and inconvertibility . Country exposure is a cross-border risk whenever a bank lends to a borrower outside its national boundaries, regardless of currency .it also exists whenever a bank extends credit in any form to borrowers located within the same country but in a currency foreign to that country.

Extensions of credit to" insiders"

Loans to insiders should be governed by the same standards applicable to any borrower, and also in compliance with prudential banking standards. The policy should ensure, through a system of controls over authority and funding, that extensions of credit to insiders are legally permissible and that credit underwriting standards are not compromised

The examiner should make a through analysis of extensions of credit to "insiders", i.e.…VIPs, directors, officers, principal shareholders, related parties, and their interests. The term "principal shareholder" means any person who owns or controls either directly or indirectly at least 10% of the outstanding stock of the designated bank or who owns or controls at least 10% of a corporation holding control of the bank . To perform the analysis, the examiner must assimilate information from other areas of examination interest. He or she should consult with examiners responsible for duties and responsibilities of directors, related organizations and the other lending areas to determine ownership data and total borrowing relationships .the examiner should note the bank's policy , whether written or implied ,relating to extensions of credit to insiders.

The examiner should endeavor to determine the existence of any preferential treatment in rate, collateral, repayment terms, or advances beyond paying capacity and any general lessening of normal credit standards. An exact definition of preferential treatment cannot be made. However, any deviation from the bank's normal banking practice for similar credits will dictate further investigation. When preferential treatment is suspected, the examiner should develop all available information supporting that contention.

In the event that a significant transaction with a director, officer, principal shareholder, or a related interest is deficient in any manner (delinquent, criticized, credit or collateral exception , preferential treatment , or violation of law), the examiner should inform senior management of his or her findings and elicit corrective action during the examination . Areas of concern involving insider transaction should be discussed thoroughly during exit review meetings with management and the board of directors. Direct communication with the field manager should precede discussion with the board of directors on serious matters of criticism. All such deficiencies and/or violations of law deserve full comment in the examination report.

Granting credit to goods dealers

Loans to carry investments in commodities entail the same basic criteria as in all credit relationships. Borrowers are typically non-producers or non-processors of the commodity, including individuals, trading companies, manufacturers, or brokers/dealers. The loan may represent a direct investment in the commodity or the carrying of a forward or futures position in the commodity. The commodity being purchased generally secures the borrowing.
Common purposes for commodity loans include:

. The temporary holding by a trader of a commodity under contract for sale, or in anticipation of sale in the near term.

. The holding of a commodity by an entity in anticipation of price appreciation for that commodity.

. The holding or inventorying by a manufacturer or fabricator awaiting transformation into some product.

The focus of the examination is on the bank's commodity lending policy and the control exercised over the collateral. The policy should address under what circumstances and conditions commodity loans will be made, particularly whether the bank will grant loans to finance a speculative position in a commodity. For secured loans, collateral margin requirement should be included in the policy.

Control of the collateral is important. Generally, the commodity will be held in a bonded warehouse, bank or other depository. The bank should control title to the commodity. Because commodity markets can become volatile, collateral positions should be monitored frequently for compliance with the policy.

Brokerage firms may borrow to finance their own positions in a commodity, or may be, in turn, financing a client. In the latter case, the dealer re-loans the borrowed funds to a customer. In some cases, the loan to the customer may represent credit for margin requirements on forward or futures contracts. Those requirements arise from a price change adverse to the holder's position in the contract both speculative and hedged positions require margin funds.

Deleted: .

EXAMINATION OBJECTIVES

1. To determine if lending policies, practices, procedures, and internal controls for commercial and industrial loans are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.

4. To determine the scope and adequacy of the audit function.

5. To determine compliance with applicable laws and regulations.

6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

EXAMINATION PROCEDURES

1. If selected for implementation, complete or update the Commercial Loan section of the Internal Control Questionnaire.

2. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.

4. Obtain a trial balance of the customer liability records and:

    a. Agree or reconcile balances to department controls and the general ledger.
    b. Review reconciling items for reasonableness.

5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.

6. Obtain the following information from the bank or other examination areas, if applicable:

    a. Past-due loans.
    b. Loans in nonaccrual status.
    c. Loans on which interest is not being collected in accordance with the terms of the loan. Particular attention should be given to loans which have been renewed with interest being rolled into principal.
    d. Loans whose terms have been modified by a reduction on interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.
    e. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
    f. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
    g. Loan commitments and other contingent liabilities.
    h. Loans secured by stock of other depository institutions.
    i. Extensions of credit to employees, officers, directors, principal shareholders and their interests, specifying which officers are considered executive officers.
    j. Extensions of credit to executive officers, directors, principal shareholders and their interests, of correspondent banks.

k. A list of correspondent banks.
l. Miscellaneous loan debit and credit suspense accounts.
m. Loans considered "problem loans" by management.
n. Specific guidelines in the lending policy.
o. Each officer's current lending authority.
p. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
q. Reports furnished to the loan and discount committee or any similar committee.
r. Reports furnished to the board of directors.
s. Loans classified during the previous examination.
t. The extent and nature of loans serviced.

7. Review the information received and perform the following for:

   a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale/purchase or asset swap:
      i. Participations Only:
         1. Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
         2. Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      ii. Procedures pertaining to all transfers:
         1. Investigate any situations where loans were transferred immediately prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
         2. Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.

   b. Miscellaneous loan debit and credit suspense accounts:

      i. Discuss with management any large or old items
      ii. Perform additional procedures as deemed appropriate.

   c. Loan commitments and other contingent liabilities – Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amount of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

   d. Loans classified during the previous examination:

      i. Current balance and payment status, or

ii. Date the loan was repaid and the source of payment.
iii. Investigate any situations where all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale or swap with another lending institution.

8. Consult with the examiner responsible for the Asset/Liability Management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources.

9. Transcribe or compare information from the schedules to commercial line cards, where appropriate.

10. Prepare commercial line cards for any loan not in the sample which, based on information derived from the above schedules, requires in-depth review.

11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and other loan areas and together decide who will review the borrowing relationship.

12. Add collateral data to line cards selected in the preceding steps.

13. Obtain credit files for all borrowers for whom commercial line cards were prepared and complete line cards. To analyze the loans, perform the following procedures:

    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as reflected in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
    d. Ascertain compliance with provisions of loan agreements.
    e. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    f. Relate collateral values to outstanding debt.
    g. Compare interest rates charged to the interest rate schedule and determine that the terms are within established guidelines.
    h. Compare the original amount of loan with the lending officer's authority.
    i. Analyze secondary support afforded by guarantors and endorsers.
    j. Ascertain compliance with the bank's established commercial loan policy.

k. Determine whether public officials are receiving preferential treatment and whether there is any correlation between loans to public officials and deposits they may control or influence.

14. For selected loans, check central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness or suspected of having additional liability in other loan areas.

15. Transcribe significant liability and other information on officers, principals and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.

16. Determine compliance with laws, rulings and regulations pertaining to commercial lending by performing the following steps for:

    a. Lending Limits:
        i. Determine the bank's lending limits as prescribed by law.
        ii. Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. Transactions with affiliates:
        i. Obtain a listing of loans to affiliates.
        ii. Test check the listing against the bank's records to determine its accuracy and completeness.
        iii. Determine that transactions with affiliates comply with legal limitations.
        iv. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
    c. Insider Lending Activities – Ensure that all insider lending activity is in compliance with legal limitations.
    d. Loans secured by Own Stock.
        i. While examining the commercial loan area, determine the existence of any loans secured by the bank's own shares.
        ii. Determine whether the bank owns any of its own shares.
        iii. In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent loss on a debt previously contracted.
        iv. In each case of ownership, determine whether the shares have been held in excess of legal limitations.

17. Perform appropriate procedural steps in the Concentration of Credits section in this manual.

18. Discuss with appropriate officers and prepare summaries in appropriate report form of:

a. Delinquent loans.
b. Violations of laws and regulations.
c. Loans not supported by current and complete financial information.
d. Loans on which collateral documentation is deficient.
e. Concentration of credits.
f. Criticized loans.
g. Inadequately collateralized loans.
h. Transfers of low-quality loans to or from another lending institution.
i. Extensions of credit to principal shareholders, employees, officers, directors and related interest.
j. Other matters regarding condition of department.

19. Evaluate the function with respect to:

    a. The adequacy of written policies relating to commercial loans.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the commercial loan department.
    d. The accuracy and completeness of the schedules obtained from the bank.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The competency of departmental management.
    h. Other matters of significance.

20. Update the workpapers with any information that will facilitate future examinations.

Introduction

This section provides guidance on the management of a bank's investment activities. The guidance applies to all securities in held-to-maturity and available for-sale accounts.

Institutions should categorize each of their security activities as trading, available-for-sale, or held-to-maturity. Management should reassess the categorizations of its securities periodically to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling in the near term should be classified as trading assets. Trading activity includes the active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized—which will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale. It is an unsafe and unsound practice to report securities held for trading purposes as available for-sale or held-to-maturity securities. A close examination of an institution's actual securities activities will determine whether securities it reported as available-for-sale or held-to-maturity are, in reality, held for trading.

Institutions must ensure that their investment activities are permissible and appropriate within established limitations and restrictions on bank holdings of these instruments. Institutions should also employ consistently sound risk-management practices. This section provides examiners with guidance on:

- The permissibility and appropriateness of securities holdings;
- Sound risk-management practices and internal controls used by banking institutions in their investment activities;
- The review of foreign securities and equity investments.

LIMITATIONS AND RESTRICTIONS ON SECURITIES HOLDINGS

Article 33 of the Banking Law specifically addresses investment restrictions as follows:

- It is prohibited for any bank without the CBI's prior approval to invest in the stocks, or equity-linked bonds of any undertaking in an amount that exceeds 20% of the bank's unimpaired capital and reserves. To the extent that any stocks, shares, or equity-linked bonds transferred to the bank in the course of its banking

operations would cause the bank's holdings to exceed such limit, the bank shall dispose of such stocks, shares, or equity-linked bonds as soon as practicable and not later than at a date at which such disposition may occur without incurring a loss, and, in any case, within two years of their acquisition at the latest. Upon request by the bank, this period may be extended for a period of up to one year by decision of the CBI.

- It is prohibited for any bank to possess shares in other banks or financial institutions without the CBI's prior approval unless such shares were transferred to the bank in the course of its banking operations. In this case, the bank shall sell the shares as soon as practicable and not later than at a date at which such disposition may occur without incurring a loss and in any case, within two years of acquiring them at the latest, unless the CBI grants approval to retain the shares.

- It is prohibited for any bank without first obtaining the CBI's prior written approval to acquire stock or shares in a company established outside Iraq, except when such stock or shares are transferred to it in the course of its banking operations.

Banks should maintain adequate credit information in their files to demonstrate that they are exercising prudent judgment in their securities transactions. All credit-related information and analyses should be retained for as long as the security remains in the bank's portfolio.

The transfer of low-quality securities from one depository institution to another may be made to avoid detection and classification during examinations; this type of transfer may be accomplished through participations, purchases or sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Broadly defined, low-quality securities include securities of questionable quality. Situations in which an institution appears to be concealing low-quality securities to avoid examination scrutiny and possible classification represent an unsafe and unsound activity. Any situations involving the transfer of low quality securities should be brought to the attention of Central Bank of Iraq supervisory personnel.

Oversight by the Board of Directors and Senior Management

Investment activities require the active oversight of the board of directors and senior management of the bank. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the

institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. Board approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. The board should actively monitor the performance and risk profile of investments in light of the established objectives, strategies, and policies. The board also should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve (1) limits on aggregate investment and exposure amounts; (2) the types of investments; and (3) appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting investment activities effectively. Appropriate internal controls should address all the elements of the investment-management process. The internal controls should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Any departures from policies and procedures should be documented and reviewed by senior management, and this documentation should be available for examiner review. As with other financial activities, the assessments of an organization's compliance with both written and implied policies and procedures should be independent of line decisionmaking functions to the fullest extent possible. When fully independent reviews are not possible in smaller, less complex institutions, alternative checks and balances should be established. These alternatives may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal-control system. This documentation should be accessible to supervisors.

EVALUATING RISK MANAGEMENT AND INTERNAL CONTROLS

Examiners are expected to conduct an adequate evaluation of the risk-management process used to acquire and manage the securities activities. In conducting this analysis, examiners should evaluate the following four key elements of a sound risk-management process:

- Active board and senior management oversight.
- Adequate risk-management policies and limits;
- Appropriate risk-measurement and reporting systems.
- Comprehensive internal controls.

As a matter of general policy, an institution should not acquire securities until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible.

Market Risk
Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights into their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach, and at least on an economic or fair value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios.

Liquidity Risk
Banks face two types of liquidity risk in their securities activities: risks related to specific products or markets and risks related to the general funding of their activities. The former, market-liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or disruptions in the marketplace. The latter, funding-liquidity risk, is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

INTERNATIONAL DIVISION INVESTMENTS

The same types of instruments exist in international banking as in domestic banking. Securities may be acquired by a bank's international division and overseas branches for its own account. The investments held by most international divisions are predominately securities issued by various governmental entities of the countries in which the bank's foreign branches are located. These investments are held for a variety of purposes:

- They are required by various local laws;
- They are used to meet foreign reserve requirements;
- They result in reduced tax liabilities;
- They enable the bank to use new or increased re-discount facilities or benefit from greater deposit or lending authorities;
- They are used by the bank as an expression of "goodwill" toward a country.

A bank's international division may also hold securities strictly for investment purposes; these are expected to provide a reasonable rate of return commensurate with safety considerations. As with domestic investment securities, the bank's safety must take precedence, followed by liquidity and marketability. Securities held by international divisions are considered to be liquid if they are readily convertible into cash at their approximate carrying value. They are marketable if they can be sold in a very short time at a price commensurate with yield and quality. Speculation in marginal foreign securities to generate more favorable yields is an unsound banking practice and should be discouraged. Institutions should categorize each of their security activities as trading, available-for-sale, or held-to-maturity. Management should reassess the categorizations of its securities periodically to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling in the near term should be classified as trading assets. Trading activity includes the active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized—which will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale. It is an unsafe and unsound practice to report securities held for trading purposes as available for-sale or held-to-maturity securities. A close examination of an institution's actual securities activities will determine whether securities it reported as available-for-sale or held-to-maturity are, in reality, held for trading.

Examination Objectives

1. To determine if policies, practices, procedures, and internal controls regarding investments are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To determine the scope and adequacy of the audit function.

4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the bank.

5. To determine compliance with laws and regulations.

6. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

Examination Procedures

1. If selected for implementation, complete or update the "Investment Securities" section of the internal control questionnaire.

2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the following examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if any corrections have been accomplished. Determine the extent and effectiveness of investment policy supervision by:

    a. Reviewing the abstracted minutes of meetings of the board of directors or appropriate committees;
    b. Determining that proper authorizations have been made for investment officers or committees;
    c. Determining any limitations or restrictions on delegated authorities;
    d. Evaluating the sufficiency of analytical data used by the board or investment committee;
    e. Reviewing the reporting methods used by department supervisors and internal auditors to ensure compliance with established policy; and
    f. Preparing a memo for the examiner who is assigned "Management and Board Processes" and the examiner who is in charge of the international examination, if applicable, stating conclusions on the effectiveness of directors' supervision of the domestic or international division investment policy. All conclusions should be documented.

4. Obtain the following:

    a. Trial balances of investment account holdings and money market instruments such as commercial paper, banker's acceptances, negotiable certificates of deposit, securities purchased under agreements to resell, etc.
    b. A list of open purchase and sale commitments
    c. A schedule of all securities purchased or sold since the last examination.
    d. A maturity schedule of securities sold under repurchase agreements.
    e. A list of pledged assets.
    f. A list of the names and addresses of all securities dealers doing business with the bank.
    g. A list of the bank's personnel authorized to trade with dealers.
    h. For international division and overseas branches, a list of investments:

        i. Held to comply with various foreign governmental regulations requiring such investments.

ii. Used to meet foreign reserve requirements;
iii. Required as stock exchange guarantees or used to enable the bank to provide securities services;
iv. Representing investment of surplus funds;
v. Used to obtain telephone and telex services;
vi. Representing club and school memberships;
vii. Acquired through debts previously contracted;
viii. Representing minority interests in nonaffiliated companies;
ix. Representing trading account securities;
x. Representing equity interests in foreign banks.
xi. Held for other purposes.

5. Obtain or prepare an analysis of investment and money market holdings that includes:

    a. A month-by-month schedule of par, book, and market values of issues maturing in one year;
    b. Schedules of par, book, and market values of holdings in the investment portfolio (schedules should be indexed by maturity date, and individual schedules should be detailed by maturity dates over the following time periods: over one through five years, over five through 10 years , and over 10 years.);
    c. For the international division, a list of international investment holdings (foreign currency amounts and Iraqi Dinar equivalents) to include:

        i. Descriptions of securities held (par, book, and market values);
        ii. Names of issuers;
        iii. Issuers' countries of domicile;
        iv. Interest rates, and
        v. Pledged securities.

6. Review the reconcilement of investment and money market account (or accounts) trial balances to the general-ledger control account (or accounts).

7. Using an appropriate technique, select from the trial balances investments and money market holdings for examination. If transaction volume permits, include all securities purchased since the last full scope examination in the population of items to be reviewed.

8. To the extent practical under the circumstances, perform credit analysis of obligors on securities. For each security where the credit analysis is performed, transcribe the following information to a separate examiner's line sheet or a related examiner's credit line sheet:

    a. Amount (and Iraqi Dinar equivalent if a foreign currency) to include part, book, and market values

b. How and when acquired;
c. Maturity date (or dates);
d. Default date, if appropriate;
e. Any pertinent comments.

9. Classify speculative and defaulted issues according to standards set by the Central Bank of Iraq. Report comments should then be drafted to include:

   a. A description of the issue;
   b. How and when each issue was acquired;
   c. The default date, if appropriate;
   d. The date interest paid to;
   e. Comments supporting the classification.

10. Review the bank's maturity program.

    a. Review the maturity schedules

       i. Compare book and market values and, after considering the gain or loss on year-to-date sales, determine if the costs of selling intermediate and long term issues appear prohibitive.
       ii. Determine if recent acquisitions show a trend toward lengthened or shortened maturities. Discuss such trends with management, particularly with regard to investment objectives approved by the investment committee.

    b. Review the pledged asset and secured liabilities schedules and isolate pledged securities by maturity segment. Then determine the market value of securities pledged in excess of net secured liabilities.

    c. Review the schedule of securities sold under repurchase agreement and determine whether:

       i. funds acquired through the sale of securities under agreement to repurchase are invested in money market assets, or if short-term repurchase agreements are being used to fund longer-term, fixed rate assets.
       ii. Whether the interest rate paid on securities sold under agreement to repurchase is appropriate relative to current money market rates; and
       iii. Whether the repurchase agreement is at the option of the buying or selling bank.

    d. Review the list of open purchase and sale commitments and determine the effect of their completion on the maturity scheduling.

e. Submit investment portfolio information regarding the credit quality and practical liquidity of the investment portfolio to the examiner who is assigned "Asset/Liability Management."

11. Determine whether the bank's investment policies and practices are satisfactorily balancing earnings and risk considerations.

    a. Calculate average yields on securities, determine if trends are apparent and the reasons for such trends.
    b. Calculate current market depreciation as a percentage of gross capital funds.
    c. Review the schedule of securities purchased and sold since the last examination and determine whether the volume of trading is consistent with policy objectives.
    d. If the majority of sales resulted in gains, determine if profit-taking is consistent with stated policy objectives or is motivated by anxiety for short-term income.
    e. Review the list of commitments to purchase or sell investments (Determine the effect of completion of these contracts on future earnings.

12. Discuss with appropriate officer(s) and prepare report comments on:

    a. Defaulted issues;
    b. Speculative issues;
    c. Incomplete credit information;
    d. Absence of legal opinions;
    e. Significant changes in maturity scheduling;
    f. Shifts in the quality of holdings;
    g. Concentrations;
    h. Unbalanced earnings and risk considerations;
    i. Unsafe and unsound investment practices;
    j. Apparent violations of law, rulings and regulations and the potential; personal liability of the directorate;
    k. Market value depreciation, if significant;
    l. Weaknesses in supervision; and
    m. Policy deficiencies

Internal Control Questionnaire

Review the bank's internal controls, policies, practices, and procedures regarding purchases, sales and servicing of the investment portfolio. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written investment securities policies that outline:

    a. Objectives;
    b. Permissible types of investments;
    c. Diversification guidelines to prevent undue concentrations;
    d. Maturity schedules;
    e. Limitation on quality ratings;
    f. Policies regarding exceptions to standard policy, and
    g. Valuation procedures and frequency?

2. Are investment policies reviewed at least annually by the board to determine if they are compatible with changing market conditions?

3. Are securities designated at time of purchase as to whether they are investments for the portfolio or trading account?

4. Have policies been established governing the transfer of securities from the trading account to the investment securities account?

5. Have limitations been imposed on the investment authority of officers?

6. *Do security transactions require dual authorization?

7. If the bank has due from commercial banks or other depository institutions time, commercial paper, securities purchased under agreements to resell, or any other money market type of investment:

    a. Is purchase or sale authority clearly defined;
    b. Are purchases or sales reported to the board of directors or its investment committee;
    c. Are maximums established for the amount of each type of asset;

d. Are maximums established for the amount of each type of asset that may be purchased from or sold to any one bank;
e. Do money market investment policies outline acceptable maturities; and
f. Have credit standards and review procedures been established?

CUSTODY OF SECURITIES

8. *Do procedures preclude the custodian of the bank securities from:

   a. Having sole physical access to securities;
   b. Preparing release documents without the approval of authorized persons;
   c. Preparing release documents not subsequently examined or tested by a second custodian; and
   d. Performing more than one of the following transactions: (1) execution of trades, receipt or delivery of securities, (3) receipt and disbursement of proceeds?

9. *Are securities physically safeguarded to prevent loss or unauthorized removal or use?

10. Are securities, other than bearer securities, held only in the name or nominee of the bank?

RECORDS

11. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected and accrued?

12. *Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?

13. *Are subsidiary records reconciled at least monthly to the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also have sole custody of securities?

14. For international investments, are entries for Iraqi Dinar carrying values of foreign currency denominated securities rechecked at inception by a second person?

PURCHASES, SALES, AND REDEMPTIONS

15. *Is the preparation and posting of security commitments purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?

16. Are supporting documents such as account statements for recorded purchases and sales checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?

17. *Are purchase confirmations compared to delivered securities or safekeeping receipts to determine if the securities delivered are the securities purchased?

OTHER

18. Does the board of directors receive regular reports on domestic and international investment securities which include:

    a. Valuations;
    b. Maturity distributions;
    c. Average yield, and
    d. Reasons for holding and benefits received?

19. Are purchases, exchanges, and sales of securities and open contractual commitments ratified by action of the board of directors or its investment committee and thereby made a matter of record in the minutes?

CONCLUSION

20. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.

21. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Deposits represent funds advanced by bank customers, which the bank is obligated to repay on demand or after a specific period of time.

Bankers place great significance on deposit growth and structure since favorable operating results depend, in part, on an expanding stable deposit base. Bank management must adopt a program consistent with the overall strategic plan to develop and retain desired deposits. The program can take the form of a board approved policy or may be included in the objectives of the strategic plan and budget. Management must also establish a procedure for determining the volatility and character of the deposit structure so that funds may be employed properly while accommodating their potential for withdrawal.

The examination process will analyze the deposit development and retention program. Examination procedures also emphasize the review of management's methods to determine and monitor the volatility and character of the deposit structure. Deposit accounts are an integral part of most banks' funds management strategy. The analysis of the deposit area should be coordinated closely with the review of the bank's funds management activities.

The deposit development and retention program includes:

- A marketing strategy.
- Projections of deposit structure and associated costs.
- A method for comparing results against projections.
- A system for revising the plan when necessary.

In creating a deposit program, management should consider:

- The composition of the market area economic base.
- The possibilities for investing deposits at a rate above associated costs.
- The competence of existing management and the location and size of banking facilities.
- The degree of competition, from banks and non bank financial institutions, and their programs to attract deposit customers.
- The effects of the national economy and government monetary and fiscal policies on the bank's service area.

The long-range success of any deposit program relates directly to the ability of

management to detect the need for change at the earliest possible time. Management information systems must be developed to monitor compliance with the deposit program and determine if adjustments should be made. Incorrect or untimely information could result in the unwise employment of funds.

Management should look, not only at deposit growth, but also at the deposit mix. Management must be able to determine the percentage of the overall deposit structure centered in stable core deposits, fluctuating or seasonal deposits, and volatile deposits. This allows for the investment of funds in view of anticipated or potential withdrawals.

The examiner analyzes the character of the overall deposit structure. The information gathered in the various examination procedures should be sufficient to allow the examiner to judge management

planning, internal control adequacy, deposit volatility, and dependence on certain deposit accounts. The examiner should be satisfied that management has planned properly for the bank's future.

Examination efforts should be directed to those types of deposit accounts shown by experience to be most significant relative to the examination objectives. The following paragraphs discuss common types of deposit accounts that, under certain circumstances, could become major problems.

Bank Controlled Accounts

Bank controlled deposit accounts are used to perform many necessary banking functions; however, the absence of sound administrative policies and adequate internal controls in that area can result in significant damage. Suspense accounts within deposit totals may be used to process unidentified, unposted, or rejected items. Characteristically, items posted to such accounts clear in one business day or less. The length of time an item remains in control accounts often reflects on the bank's operational efficiency

Official check accounts are controlled and reconciled by bank personnel. They reflect the bank's promise to pay a specified sum upon presentation of an official check. Operational inefficiencies that allow a significant understatement of the bank's liability can have serious consequences. Misuse of official checks may result in substantial losses.

Cash collateral, dealer's differential or reserve, un-advanced loan proceeds, and various types of loan escrow accounts are also a source of potential loss. The risk lies in inefficiency or misuse such that the accounts become overdrawn or that they are used to pay principal or interest on bank loans. Funds deposited to these accounts should only be used for their stated purposes.

There are many other types of bank-controlled deposit accounts that management uses in the normal course of business. To insure that such accounts are properly administered and soundly used, the directorate must see that operating policies are in effect defining their purpose and uses, acceptable entries, the manner of posting various types of entries, and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to bank controlled accounts, determine the responsibility for frequency of reconcilement, and discourage improper posting of items and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

Out-of-Area Accounts

A small or medium-sized bank's dependence on the deposits of customers who reside or conduct their business outside of the bank's normal service area should be closely monitored by the bank and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service. However, large out-of-area deposits are sometimes attracted by liberal credit accommodations or by paying

significantly higher rates of interest than offered by competitors. That type of deposit growth generally proves costly in terms of credit risks taken to support an unstable deposit structure. Banks outside money market centers are limited because they usually can only support stable deposit growth by prudent reinvestment of localized source funds. Deposit development and retention policies must recognize the limits imposed by prudent competition and the bank's service area.

Public Funds

Public funds deposits should be reviewed by the examiner because of their size and potential volatility. They normally fluctuate on a seasonal basis because of timing differences between tax collections and expenditures. Government officials controlling public deposits have a responsibility to insure that such deposits are placed with a bank that can provide or arrange the best banking service at the least cost. Banks that offer competitive interest rates and provide collection, financial advisory, underwriting, and data processing services at competitive costs are frequently chosen as depositories. Public funds deposits acquired through political influence are always regarded as volatile.

Employee Accounts

Irregularities have been disclosed by reviews of employee deposit accounts. Bank employees should be encouraged to maintain accounts with their employer, and those accounts should be segregated or specially encoded to encourage periodic internal supervisory review. Bank policy should establish standards for maintenance and review of employee accounts.

Overdrafts

The size, frequency, and duration of deposit account overdrafts are matters that should be governed by bank policy and controlled by adequate internal controls, practices, and procedures. Overdraft approval authority should be assigned in the same manner as is lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so that account officers who are less than objective do not allow influential customers to exploit their overdraft privileges. Overdraft charges should discourage frequent usage, but penalty fees should never be considered an important source of income.

Check Kiting

Check kiting is a potential hazard for any bank, and management must be on constant guard against it. Check kiting occurs when a depositor with accounts in two or more banks acquires unauthorized funds by relying on the time required for checks to clear. The key to the whole scheme is the ability to be drawing against uncollected funds. However, the fact that a depositor is doing so does not necessarily indicate kiting. Any such activity should, however, be closely monitored by management. Management should approve those depositors authorized to draw against uncollected funds, and unauthorized activity should be investigated. Banks should maintain internal controls to preclude loss from kiting.

Dormant and Abandoned Property

Another area of possible exposure is in the handling of dormant accounts and associated records. Standards should be established by bank management that clearly outline the bank's policy for the effective control of dormant accounts. Those standards should cover:

- The types of deposit accounts that will be designated as dormant, such as demand, savings, and official check.

- The time elapsed between the last customer originated activity and its classification as dormant.

- The controls exercised over the accounts and their signature cards. Accounts classified as dormant should be closely controlled to minimize the possibility of manipulation.

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts. The board of directors should review the basis upon which service charges on dormant accounts are assessed. The review should be documented in the board minutes.

Zero Balance Accounts

Zero balance accounts are demand deposit accounts through which checks or drafts are received for either deposit or payment. The total amount received on any day is offset by a corresponding debit or credit to maintain the account at or near a zero balance. Zero balance accounts enable the corporate treasurer to monitor effectively cash receipts and disbursements.

For example, a corporation may pay large bills with checks drawn on an account carrying a nominal balance. As the checks arrive for payment, they are charged to a zero balance account, with the expectation that funds to cover the checks will be deposited before the end of the banking day. Several methods used to cover checks include:

- Wire transfers.
- Depository transfer checks -- a bank-prepared-payments instrument used to transfer money from a corporate account in one bank to another.
- Concentration accounts -- a corporate demand deposit account used as a clearing account for receipts and/or disbursements.
- Extended settlement -- a cash management arrangement which does not require the corporate customer to provide same day funds for payment of its checks.

Since checks are covered before the close of business on the day they arrive, the bank's exposure is not reflected in the financial statement.

However, the bank assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit. The absence of prudent safeguards and full knowledge of the creditworthiness of the depositor may expose the bank to large, unwarranted, and unnecessary risks.

Bank examiners should be alert to such activities. They should routinely review cash management policies and procedures to assure that banks are not engaging in unsafe and unsound banking practices or illegal transactions. The examination procedures and internal control questions regarding payment of items against uncollected funds provide some guidance for that review. When imprudent operations are discovered, appropriate comments should appear in the report of examination. The examiner should direct the bank to take corrective action. Because of the risks involved, discovery of imprudent operations should be immediately communicated to Bank Supervision Department management to speed corrective action.

Deposit Accounts

Deposit accounts and services must be priced accurately to adequately offset interest costs. The failure to properly price bank activities could affect earnings seriously. Service charges may be imposed either as a monthly fee or as a charge for each instrument that is written or for each transfer made. Additionally, the charge may take the form of an interest forfeiture.

The examiner should consider the following items when evaluating the effect of deposit costs on bank earnings.

- The trend of net interest income.
- Service-charge income.
- Projected operating costs.
- Marketing costs.
- Adequacy of strategic planning process.

Examiners must analyze the effect of deposit interest expense on the financial condition of the bank and the quality and scope of management's planning. Examiners performing "Funds Management" and "Analytical Review of Income and Expense" should be informed of any significant deposit growth or changes in deposit mix.

EXAMINATION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.

2. To determine if the deposit development and retention program is consistent with the bank's overall strategic plan and budget.

3. To determine if management information systems provide the necessary information for informed deposit decisions and the monitoring of their results.

4. To determine if bank officers are operating in conformance with the established guidelines.

5. To evaluate the deposit structure and determine its character and volatility.

6. To determine the scope and adequacy of the audit function.

7. To determine compliance with applicable laws, rulings, and regulations.

8. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been noted.

EXAMINATION PROCEDURES

1. Complete or update the Deposit Accounts section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls and the work performed by internal/external auditors (see separate program), determine the scope of the examination. Select from among the following examination procedures those steps that are necessary to evaluate the bank's deposit account practices.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the selected examination procedural steps. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal and External Audits," and determine if appropriate corrections have been made.

4. Perform appropriate verification procedures.

5. Obtain or prepare, as applicable, the following listed reports. On an automated system, the examiner should use available bank copies of printouts plus transactions journals, microfiche, or other visual media to minimize expense to the bank. On a manual system, the information necessary to complete the examination procedures and indicated verification procedures is left to the examiner's discretion.

    a. For demand deposits and other transaction accounts:

        - Trial balance(s).
        - Overdrafts.
        - Unposted items.
        - Dormant accounts.
        - Public funds.
        - Trust department funds.
        - Uncollected funds.
        - Due to banks.
        - Average balance.
        - Significant change.

- Demand certificates of deposits.
- Large balance report.

b. For official checks:

- Trial balance(s).
- Exception list.
- Checks paid without credit.

c. For savings accounts:

- Trial balance.
- Unposted items.
- Overdrafts.
- Dormant accounts.
- Public funds.
- Trust department funds.

d. For other time deposits:

- Trial balance(s).
- Unposted items.
- Public funds.
- Trust department funds.

e. For certificates of deposit:

- Trial balance(s).
- Unposted items.
- Public funds.
- Certificates of USD or equivalent $100,000 and over.
- Maturity reports.

- Matured certificates of deposit.
- Brokered deposits.

f. For bank controlled accounts:

- Reconcilement records for all such accounts (return to bank).
- Name and phone extension of reconcilement clerk(s).

6. Review the reconcilement's of all types of deposit accounts, and agree the balances to department controls and the general ledger, then:

   a. Determine if reconciliation items are reasonable.

   b. Retain custody of all trial balances only if necessary and practical.

7. Review the reconciliation process for bank controlled accounts, such as official checks and escrow deposits, and:

   a. Determine if reconciling items are reasonable.

   b. Scan activity in such accounts to determine the potential diversion of funds for:

      - Loan payments (principal and interest).
      - Personal use.
      - Other

8. Review the bank's operating procedures and reconciliation process relative to suspense accounts, and determine if:

   a. The disposition process of unidentified items is completed in a timely fashion.

   b. Reports are generated to periodically inform management of the type, age, and amounts of items in such accounts.

9. Evaluate the effectiveness of procedures regarding overdrafts and drawings against uncollected funds by:

   a. Reviewing procedures and policies for extensions of credit by such methods to determine that:

      - Officer approval limits have been established.

- A formal system of review and approval is in effect.

b. Ascertaining the adequacy of the bank's policies and reporting methods regarding drawings against uncollected funds by determining that:

- The uncollected funds report reflects balances as uncollected until they are actually received.
- Management is effectively comparing reports of significant changes in balance and activity volume to uncollected funds reports.
- Management knows the reasons why a depositor is frequently drawing against uncollected funds.
- A reporting system to inform senior management of significant activity in this area has been instituted.
- Appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential kiting operations.

c. Determining whether formal overdraft agreements exist and, if so:

- Obtain trial balance or list of the agreements.
- Cross-reference trial balance or list to credit line slips of various loan departments.
- Work credit files on significant formal agreements not crossed above.

d. Performing the following:

- Cross-reference overdraft and uncollected funds reports to credit line slips of the various loan departments.
- Work credit files on significant overdrafts and depositors who frequently draw significant amounts against uncollected funds not crossed above.
- Request management to charge uncollectable overdrafts to the reserve for loan and lease losses.
- Submit a list of overdrafts considered loss and the total amounts overdrawn 30 days or more to the examiner assigned "Loan Portfolio Management."

10. Review the bank's deposit development and retention program to determine if it:

a. Includes a marketing strategy that addresses:

- Advertising.
- Goods and services offered as inducements to potential deposit customers.
- Competitive rates.
- Indication of types of deposits desired, such as time and/or demand deposits of individuals, corporations, or public entities.

b. Includes projections of anticipated deposit structure and interest costs of such a structure, indicating percentages of time and demand deposits of:

- Individuals.
- Corporations.
- Public entities.

c. Includes a periodic comparison of performance to projections, including periodic reports to management indicating results and the accuracy of anticipated costs.

d. Is consistent with and/or included in the bank's overall strategic plan and budget.

11. Analyze the data on deposits and related expense ratios, and compare to peer group norms to determine:

a. Variations from the norm.

b. Trends in the deposit structure with respect to:

- Growth patterns.
- Shifts between deposit categories.

12. Determine the volatility and the character of the bank's deposit structure by:

a. Reviewing the list of time certificates of deposit of USD or equivalent $100,000 and over, and related management reports to determine:

- The aggregate USD volume of bearer CD's, if significant.

- The aggregate USD volume of accounts of depositors outside the bank's normal service area, if significant.

- If the bank is paying competitive rates on CD's.

- The aggregate USD volume of money market CD's with interest rates higher than current publicly quoted rates within the industry, if significant.

- The USD amount of brokered CD's, if any

b. Reviewing public funds and the bank's method of acquiring such funds to determine if competitive bidding is used in determining the interest rate paid on public deposits. If so, does the bank consider the potential for purchasing public debt, the interest rate to be paid thereon, and the cost of accommodation services in computing their bid?

c. Reviewing appropriate trials for all other deposits and/or management reports that relate to large deposits for individuals, partnerships, corporations, and related deposit accounts. Discuss with management any concentration of deposits and the ability to retain/replace those funds.

d. Eliciting management's comments to determine:

- The potential renewal of large CD's that mature within the next 12 months.

- If public fund deposits have been obtained through political influence.

- If a significant USD volume of accounts is concentrated in customers engaged in a single business or industry.

- If there is a significant USD volume of deposits of customers who do not reside within the bank's service area.

- Other negative factors which affect the retention of deposits.

13. Discuss deposit character and volatility with the examiner assigned "Funds Management." Determine his/her need for such deposit information as:

- The amount of any anticipated deposit decline or increase in the next _____day period.

  (Time period to be determined by the examiner reviewing Funds Management.)

- A listing by name and amount of large deposit customers.

- A repricing schedule of interest-bearing deposits.
- The level and reliance on negotiable certificates of deposit.
- The aggregate amount of brokered deposits.
- A statement regarding the overall character and volatility of the deposit structure.

14. Determine the financial impact of interest bearing transaction accounts on the bank. Discuss with management the cost and stability of those deposits and the investment opportunities they afford.

15. Provide a list of due to banks to the examiner assigned to "Loan Portfolio Management."

16. Obtain information on competitive pressures and economic conditions from the examiner assigned "Overall Conclusions," and evaluate that information, along with current trends in deposits and present marketing techniques, to estimate their affect on the bank's deposit structure.

17. Test for compliance with applicable laws, rulings, and regulations by performing the following for:

    a. Reserve Requirements: Review the deposit data used in the bank's calculation of its reserve requirement for the examination date and the previous reporting period.

18. Discuss findings with appropriate officer(s), and prepare report comments on:

    a. Policy deficiencies.

    b. Weaknesses in supervision.

    c. Apparent violations of laws, rulings, and regulations.

    d. Possible conflicts of interest.

19. Reach a conclusion regarding the quality of department management.

20. Prepare a memorandum, and update work programs with any information which will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures for deposit accounts. The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with asterisks require substantiation by observation or testing.

Questions Pertaining to Both Transaction and Time Deposit Accounts:

Opening New Accounts

1. (*) Are account ledgers pre-numbered? And:

    a. Are they issued in strict numerical sequence?

    b. Is the unused supply accessible only to a custodian who is not a teller?

2. (*) Is the opening of new accounts handled by someone other than a teller?

3. Are new account signature cards for transaction accounts reviewed by an officer?

Closing Accounts

4. Are signature cards for closed accounts promptly pulled from the active account file and placed in a closed one?

5. Are closed account lists prepared (if so, indicate frequency _____)?

6. (*) Is the closed account list circulated among officers?

7. Is verification of closed accounts, in the form of statements of "goodwill" letters, required, and are they mailed under the control of someone other than a teller?

Account Records

8. For signature cards:

    a. Are procedures in effect to guard against the substitution of false signatures (if so, describe the procedure)?

    b. Are signature cards stored to preclude physical damage?

    c. Are signature cards compared to withdrawal signatures (if so, describe procedures)?

9. (*) Is the preparation, addition, and posting of subsidiary demand deposit records performed and/or adequately reviewed by persons who do not also:

a. Work on the teller line?

b. Issue official checks singly?

c. Handle signed official checks?

d. Prepare all supporting documents required for disbursement from an account?

10. (*) Are subsidiary deposit records reconciled to the general ledger accounts and reconciling items adequately investigated by persons who do not also:

    a. Work on the teller line?

    b. Post transactions to such records?

11. Are account trial balances prepared on a periodic basis (if so, how often _____)?

12. (*) Are deposit controls reconciled to the general ledger daily?

13. Are reconcilement's reviewed by an independent officer?

14. (*) Are reconcilement duties rotated on a formal basis?

15. Does the bank segregate deposit account files of:

    a. Employees and officers?

    b. Directors?

    c. Business interests of, or controlled by, employees and officers?

    d. Business interests of, or controlled by, directors?

Dormant Accounts

16. Is an account which has been inactive for a period of 1 year considered dormant (if not, state time period _____)?

17. Is the size of an account irrelevant to whether it will be considered dormant?

18. (*) If the appropriate time has elapsed and the account has not been placed in dormant status, must the reason be documented?

19. (*) Are dormant accounts segregated in the ledgers?

20. (*) Are dormant signature cards maintained under dual control?

21. (*) Are transactions on dormant accounts initialed by an officer at the point of origination to indicate approval?

22. (*) Does transfer from dormant to active status require approval of an officer who cannot approve transactions on dormant accounts?

Other

23. (*) If not included in the internal/external audit program, are employee and officers' accounts, accounts of their business interests, and accounts controlled by them periodically reviewed for abnormal activity?

24. For unidentified deposits:

    a. Are deposit slips on such deposits kept under dual control?

    b. Is their disposition approved by an appropriate officer?

25. (*) For returned checks, unposted items, and other rejects:

    a. Are daily listings of such items prepared?

    b. Are all items reviewed daily, and is disposition of items required within a given time period (if so, indicate time period _____)?

26. Are customers immediately notified, in writing, of deposit errors?

27. For mailing or delivery of statements:

    a. Are statements mailed or delivered to all customers with transaction accounts at least monthly?

    b. Are statements mailed or delivered to customers with time deposit accounts (if so, how often _____)?

    c. Are statements periodically mailed on dormant accounts (if so, how often _____)?

    d. Do procedures exist to prohibit the delivery of statements to officers and employees for special attention?

    e. Is written authorization required from customers for "no mail" and "hold for pick-up" statements?

    f. Are statements held for pick-up under dual control?

    g. Are customers required to sign for statements held for pick- up?

h. Are those signatures compared to the authorized ones on file for that purpose?

i. Must change of address requests be in writing and signed by the depositor?

28. For telephone transfer accounts:

    a. Do depositors receive an individual identification code for use in making transfers?

    b. Are transfers made by employees who do not also handle cash, issue official checks singly, or post subsidiary records?

Questions Pertaining to:

Transaction Accounts Only

29. Are officer overdraft approval limits formally established?

30. (*) Is an overdraft listing prepared daily?

31. (*) Is that listing circulated among the officers?

32. (*) Do overdrafts require the approval of an authorized officer?

33. Are the statements of larger overdrawn accounts reviewed for irregularities?

34. Is a record of overdrafts included in the monthly reports to the board of directors or its committee?

35. Is there an established schedule of service charges?

36. If the bank's bookkeeping system is not automated, are transaction deposit bookkeepers rotated?

37. (*) If the system is automated, are input and reconciling duties segregated?

38. (*) Do all internal entries other than service charges require the approval of appropriate officers?

39. (*) For uncollected funds:

    a. Does the bank receive or prepare a daily report of drawings against uncollected funds?

    b. Does an authorized officer review that report?

    c. Must an officer approve any draw against uncollected funds?

40. (*) Are deposit and check filing separated from statement preparation?

41. Does the bank require a signature for stop payment orders?

42. For automatic transfer accounts:

    a. Are procedures in effect which require officer approval for transfers in excess of savings balances?

    b. For non-automated systems, are transfers made by employees who do not also handle cash, issue official checks singly, or post subsidiary ledgers?

Questions Pertaining to:

Time Deposits Only

43. When opening a new certificate of deposit (CD):

    a. If the bank has branch operations, are inventory records maintained to show the inclusive numbers of blocks assigned to each office.

    b. Are individuals issuing or approving CD's required to sign them?

44. For redeemed CD's:

    a. Are they stamped paid?

    b. Is disposition of proceeds documented to provide a permanent record as well as provide a clear audit trail? (Preferably, the disposition should be documented on the face of the paid receipt.)

45. Are matured CD's not automatically renewable classified as demand deposits?

46. Are notices of interest credited to savings accounts sent directly to the depositor, and does that notice reflect the account balance?

47. Is the mailing of interest notices handled only by persons who do not also handle cash?

48. If not included in the internal/external audit program, are accrual balances for the various types of deposits verified periodically by an authorized official (if so, how often _____)?

49. Are subsidiary records "marked" for accounts pledged as security to customers' loans or for lost passbooks?

50. Are ruined CD's voided and kept for future reference?

51. In banks which use passbooks:

a. Do all entries to passbooks contain teller identification?

b. Are tellers prohibited from holding customers' passbooks?

c. (*) If customers' passbooks are held, are they kept under dual control by individuals who are not tellers?

d. Are customers prohibited from withdrawing funds without a passbook (if not, state policy)?

52. For withdrawals in non-passbook systems:

a. Are withdrawal tickets canceled daily?

b. Are procedures in effect to preclude overdrafts (if so, indicate procedure)?

c. Are procedures in effect to check for, or place holds on, accounts if withdrawals are over a stated amount (if so, indicate amount USD or equivalent _____)?

Official Checks

53. Are separate general ledger accounts maintained for each type of official check?

54. As to the types of checks used:

a. Are multi-copy checks used?

b. If not, are detailed registers of disbursed checks maintained?

c. Are all checks pre-numbered?

d. Is check preparation and issuance separate from recordkeeping?

e. Is the signing of checks in advance prohibited?

55. Is the signing authorization list kept current (changes should include employees added to the authorization list, changes in authorization limits, and employees terminating)?

56. If a check signing machine is used, are appropriate controls in effect (if so, indicate controls)?

57. Are voided checks properly mutilated and filed with paid checks?

58. For reconcilement's:

a. Are outstanding checks listed and reconciled regularly to the general ledger (if so, how often _____)?

b. Is permanent evidence of reconcilement's maintained?

c. Are the reconcilement's reviewed regularly by an authorized officer?

d. Are reconcilement duties rotated on a formal basis?

e. Are signatures and endorsements checked by the filing clerk?

59. For supplies of official checks:

a. Are records kept of unissued official checks on hand?

b. Are periodic inventories taken by someone other than the individuals in control of the checks?

c. If users are assigned a supply, is the supply replenished on a consignment basis?

60. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

61. Is a copy or the original of the following records retained for 5 years:

a. Signature cards?

b. Statement ledger or other record reflecting each deposit account's transactions?

c. Each item, other than bank charges or periodic charges made pursuant to an agreement with the customer, charged to a deposit account?

d. Records providing the name, address, and taxpayer identification number of the purchaser of each certificate of deposit, as well as the date and description of the instrument and a notation of the method of purchase (check, cash, etc.)?

e. Records providing the name, address, and taxpayer identification number of any person presenting a certificate of deposit for payment as well as a description of the instrument and the date of the transaction?

62. Are records sufficient to reconstruct a demand deposit account and to trace a check deposited in such an account through its domestic processing system or to supply a description of a deposited check retained for 2 years?

Deposit Accounts Conclusion

63. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

64. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal controls for deposit accounts is considered _____(good, medium, or bad).

VERIFICATION PROCEDURES

1. Test the addition of all trial balances and the reconciliation to the general ledger.

2. Using appropriate techniques, sample the entire deposit structure as a single population, and select deposits of all types from the trial balance, and:

    a. Prepare and mail confirmation forms to the depositors selected.

    b. After a reasonable time period, mail second requests (if positive confirmation was used).

    c. Follow-up on any no-replies or exceptions, and resolve differences.

3. For transaction accounts selected in step 2:

    a. Verify the computation of service charges for at least one account from each type of transaction account selected, and trace them to the appropriate income account.

    b. Determine, on a test basis, if insufficient funds and overdraft charges are properly collected, and trace them to the appropriate income account.

    (Steps a. and b. should be coordinated with the examiner assigned "Analytical Review and Income and Expense" to avoid possible duplication of efforts.)

    c. Determine the reasons for statements noted for "no mail" or "hold for pick up," and examine appropriate authorization signed by the customer.

    d. Determine if a properly signed authority to charge is in evidence for accounts which have an automatic deduction by the bank.

    e. Investigate bank controlled accounts such as dealers' reserves and cash/collateral accounts to determine the validity of entries and of notification procedures to the customer of activity.

    f. Determine if unidentified funds are properly segregated, that disposition is on a timely basis, and that items are transferred to a dormant account after 1 year.

    g. Mail cutoff statements, to include debit and credit memos and drafts, and an appropriate reconciling form to due to banks accounts selected. Have the reconcilement completed and returned. Investigate significant items used to reconcile and follow through to disposition.

    h. Review the reports on drawings against uncollected funds and significant changes to determine possible kiting. Request statements and copies of checks and deposit media to further investigate those selected. If the period

for preparing uncollected funds reports is not considered adequate, at least 3 days, perform the following steps:

- Look at 5 days of reports on uncollected funds, large balances, and significant changes for unusual depositor activity. Select account names and numbers that appear on the reports twice or more, and eliminate large depositors who are known to deposit cash or own bank checks to corporate clearing accounts.

- For the remaining accounts, review canceled checks and deposit slips or cash letter items to determine if checks paid and checks deposited are controlled by the same or related parties.

i. Determine that collections deposited in escrow funds are properly credited and that debits made against the account are for proper disbursements.

j. Review the debit and credit entries made on dormant accounts, and determine validity and conformity to bank policy.

4. For savings and time deposit accounts, selected in step 2:

   a. Determine the reasons for savings account statements noted for "hold for pick-up" or "no mail," and examine appropriate authorizations signed by the customers.

   b. Determine that accounts pledged are noted on the trial balance to prevent withdrawal of funds without officer approval.

   c. Review the debit and credit entries to dormant accounts, and determine validity and conformity to bank policy.

   d. Determine if unidentified funds are properly segregated and if disposition is on a timely basis. Also, ensure that items are transferred to a dormant account after 1 year.

5. For official checks:

   a. If accounts are on computer, reconcile the cutoff statements as of the examination date to bookkeeping totals, and run a list of duplicate outstanding checks.

   b. If accounts are manual, run a tape listing of the outstanding checks or the check register, and balance to the general ledger totals.

   c. Review the copies of the outstanding checks for unusual items or stale dated checks.

   d. Determine that stale checks are segregated, and review the entries to ascertain validity.

e. Determine that all outstanding checks have been included as liabilities by obtaining control over paid checks for a number of days after the examination has begun, and:

- Indicate any checks paid before the liability was posted.
- Inspect the paid checks for authorized signatures and endorsements.

f. Determine that the bank is issuing checks in numerical sequence, and make an inventory of unissued checks by type. Agree the inventory to office control, and resolve any differences.

6. Compare the accounts selected from the last examination to the current trial balance to determine if any of those accounts were closed, or, if none were noted, select accounts from the closed account list and send confirmations.

7. Review stop payment orders, and compare a representative number to the trial balance to determine if accounts are properly noted.

8. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances at each quarter-end since last examination, and:

   a. Calculate ratios.

   b. Investigate significant fluctuations and/or trends.

9. Test interest expense by computing interest expense based on average deposits and interest rates on a quarterly basis. Compare the computed amount to the actual recorded expenses. (This step should be performed only if the examiner-in-charge determines that it is necessary.)

10. If the bank uses pre-numbered CD forms, determine that certificates are issued in numerical order. Inventory the unissued certificates, and agree the inventory to office control and resolve differences.

11. Determine that the bank only holds passbooks on accounts that are pledged as collateral for loans.

Introduction

Borrowed funds are a common and practical method for banks of all sizes to meet customers' needs and enhance banking operations. For the purposes of this section, borrowings exclude long-term subordinated debt such as capital notes and debentures. Borrowings may exist in a number of forms, both on a direct and indirect basis. Common sources of direct bank borrowings include Central Bank of Iraq credit lines, loans from correspondent banks, and repurchase agreements and mortgages payable. Indirect forms of borrowings include customer paper rediscounted and assets sold with the bank's endorsement or guarantee or subject to a repurchase agreement.

The primary reasons a bank may borrow include the following:

- To meet the temporary or seasonal loan or deposit withdrawal needs of its customers, if the borrowing period is temporary and the bank is quickly restored to a position in which the quantity of its principal earning assets and cash reserves is in proper relation to the requirements of its normal deposit volume.

- To meet large and unanticipated deposit withdrawals that may arise during periods of economic distress. The examiner should distinguish between "large and unanticipated deposit withdrawals" and a pre-determinable contraction of deposits, such as the cessation of activities in a resort community or the withdrawal of funds on which the bank received adequate prior withdrawal notice. Those situations should be met through ample cash reserves and readily convertible assets rather than borrowing.

- To manage liabilities effectively. Generally, the effective use of this type of continuous borrowing is limited to money-center or large regional banks.

It is important to analyze each borrowing on its own merit to determine its purpose, effectiveness, and stability. Typical sources of borrowings include the following:

- Loans from Correspondent Banks – Small and medium-sized banks often negotiate loans from their principal correspondent banks. The loans are usually for short periods and may be secured or unsecured.

- International Borrowings – International borrowings may be direct or indirect. Common forms of direct international borrowings include loans and short-term money from foreign banks, borrowings from the Export-Import Bank of the United States, and overdrawn nostro (due from foreign banks-demand) accounts. Indirect forms of borrowing include notes and trade bills rediscounted with the central banks of various countries; notes, acceptances, import drafts, or trade bills

sold with the bank's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements.

ANALYZING BORROWINGS

If a bank borrows extensively or in large amounts, the examiner should thoroughly analyze the borrowing activity. An effective analysis includes a review of the bank's reserve records, both required and maintained, to determine the frequency of deficiencies at the closing of reserve periods. The principal sources of borrowings, range of amounts, frequency, length of time indebted, cost, and reasons for the borrowings should be explored. The actual use of the funds should be verified. Examiners should also analyze changes in a bank's borrowing position for signs of deterioration in its borrowing ability and overall creditworthiness. One indication of deterioration is the payment of large fees to money brokers to obtain funds because the bank is having difficulty obtaining access to conventional sources of borrowings. These ''brokered deposits'' are usually associated with small banks since they do not generally have ready access to alternative sources of funds available to larger institutions through the money and capital markets. Brokered deposits generally carry higher interest rates than alternative sources, and they tend to be particularly susceptible to interest-rate changes in the overall financial market.

Other indicators of deterioration in a bank's borrowing ability and overall creditworthiness include, but are not limited to, requests for collateral on previously unsecured credit lines or increases in collateral margins, the payment of above-market interest rates, or a shortening of maturities that is inconsistent with management's articulated balance-sheet strategies. If the examiner finds that a bank's borrowing position is not properly managed, appropriate comments should be included in the report of examination.

Examination Objectives

1. To determine if the policies, practices, procedures, and internal controls for borrowed funds are adequate.

2. To determine the scope and adequacy of the audit function.

3. To determine compliance with laws and regulations.

4. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Examination Procedures

1. If selected for implementation, complete or update the Borrowed Funds section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls and the work performed by the internal/external auditors, determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors and determine if appropriate corrections have been made.

4. Obtain the listing of accounts related to domestic and international borrowed funds.

5. Prepare or obtain a listing of borrowings, by type, and:

    a. Agree or reconcile balances to department controls and general ledger;
    b. Review reconciling items for reasonableness.

6. From consultation with the examiners assigned to the various loan areas, determine that the following schedules were reviewed in the lending departments and that there was no endorsement, guarantee or repurchase agreement which would constitute a borrowing:

    a. Participations sold;
    b. Loans sold in full since the preceding examination.

7. Based on the information obtained in steps 5 and 6, and through observation and discussion with management and other examining personnel, determine that all borrowings are properly reflected on the books of the bank.

8. If the bank engages in any form of borrowing which requires written borrowing agreement(s), complete the following:

    a. Prepare or update a carry-forward workpaper describing the major terms of each borrowing agreement, and determine that the bank is complying with those terms.
    b. Review terms of past and present borrowing agreements for indications of deteriorating credit position by noting:

i. Recent substantive changes in borrowing agreements;
ii. Increases in collateral to support borrowing transactions;
iii. General shortening of maturities;
iv. Interest rates exceeding prevailing market rates;
v. Frequent changes in lenders; and
vi. Large fees paid to money brokers.

c. If the bank has obtained funds from money brokers (brokered deposits), determine:

i. Why such deposits were originally obtained;
ii. Who the deposits were obtained from;
iii. What the funds are used for;
iv. The relative cost of brokered deposits in comparison to alternate sources of funds; and
v. The overall effect of the use of brokered deposits on the bank's condition and whether there appear to be any abuses related to the use of such deposits.

d. If there is an indication that the bank's credit position has deteriorated, ascertain why.

9. Determine the purpose of each type of borrowing and conclude whether the bank's borrowing posture is justified in light of its financial condition and other relevant circumstances.

10. Provide the examiner assigned to "Asset/Liability Management" the following information:

a. A summary and an evaluation of the bank's borrowing policies, practices and procedures. The evaluation should give consideration to whether the bank:

i. Evaluates interest-rate-risk exposure at various maturity levels;
ii. Formulates policy objectives in light of the entire asset and liability mix, and liquidity needs;
iii. Has adopted procedures to control mismatches between assets and liabilities; and
iv. Has contingency plans for alternate sources of funds in the event of a run-off of current funding sources.

b. An evaluation of the bank's adherence to established policies and procedures.

c. A repricing maturity schedule of borrowings.

d. A listing of prearranged credit lines. Indicate the amount currently available under those lines, i.e., the unused portion of the lines.

e. The amount of any anticipated decline in borrowings over the next day period. (The time period will be determined by the examiner assigned to "Asset/Liability Management".)

11. Prepare a list of all borrowings by category, on a daily basis for the period since the last examination. For each category on the list, compute for the period between examinations:

    a. High point;
    b. Low point;
    c. Average amounts outstanding;
    d. Frequency of borrowing and lending activity, expressed in terms of number of days.

12. Prepare, in appropriate report form, and discuss with appropriate management:

    a. The adequacy of written policies regarding borrowings;
    b. The manner in which bank officers are operating in conformance with established policy;
    c. The existence of any unjustified borrowing practices;
    d. Any violation of laws or regulations; and
    e. Recommended corrective action when policies, practices, or procedures are deficient, violations of laws or regulations exist, or when unjustified borrowing practices are being pursued.

13. Update the workpapers with any information that will facilitate future examinations.

Internal Control Questionnaire

Review the bank's controls, policies, practices and procedures for obtaining and servicing borrowed funds. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICY

1. Has the board of directors approved a written policy which:

    a. Outlines the objectives of bank borrowings?
    b. Describes the bank's borrowing philosophy relative to risk considerations, i.e. leverage/growth, liquidity/income?
    c. Provides for risk diversification in terms of staggered maturities rather than solely on cost?
    d. Limits borrowings by amount outstanding, specific type or total interest expense?
    e. Limits or restricts execution of borrowings by bank officers?
    f. Provides a system of reporting requirements to monitor borrowing activity?
    g. Requires subsequent approval of transactions?
    h. Provides for review and revision of established policy at least annually?

RECORDS

2. *Does the bank maintain subsidiary records for each type of borrowing, including proper identification of the oblige?

3. *Is the preparation, addition and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:

    a. Handle cash?
    b. Issue official checks and drafts?
    c. Prepare all supporting documents required for payment of debt?

4. *Are subsidiary borrowed funds records reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons, who do not also:

    a. Handle cash?
    b. Prepare or post to the subsidiary borrowed funds records?

INTEREST

5. *Are individual interest computations checked by persons who do not have access to cash?

6. Is an overall test of the total interest paid made by persons who do not have access to cash?

7. Are payees on the checks matched to related records of debt, note or debenture owners?

8. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?

9. Are monthly reports furnished to the board of directors reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date and anticipated future activity?

CONCLUSION

10. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

11. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Determining the adequacy of a bank's capital is important, not only to assess the strength of an individual bank, but also to evaluate the safety and soundness of the entire banking system. The CBI also reviews capital adequacy in taking action on various types of applications such as mergers and branches. Bank capital helps to:

- Assure public confidence in the stability of individual banks and the commercial banking system.
- Support the volume, type, and character of the business conducted.
- Provide for the possibilities of inherent loss.
- Assure the risks in commercial banking are distributed appropriately between the private and banking sector.
- Permit the bank to continue to meet the reasonable credit requirements of their community.

Therefore, the supervisory process must continually assess whether a bank's level of capital is sufficient to permit it to operate as a viable institution. A comprehensive evaluation of capital adequacy considers a wide range of both quantitative and qualitative factors. Quantitative measures of capital adequacy are commonly expressed as ratios. Qualitative factors include, among other things, a bank's liquidity position, management quality, asset quality, and earnings capacity.

Quantitative Factors

Evolution of Capital Adequacy Measures

Banking supervisors have historically employed minimum ratios relating capital to total assets in the assessment of capital adequacy of banks. These ratios have evolved over time.

Under the auspices of the Bank for International Settlements' Committee on Banking Regulations and Supervisory Practices (the Basle Committee), banking regulators worked with the supervisory authorities of twelve member nations to develop a common framework for measuring capital adequacy, including minimum capital standards for internationally active banks. The international agreement was formally approved in July, 1988.

Risk-Based Capital Guidelines

Based on the international framework, the CBI developed and adopted risk-based capital guidelines for all Iraqi banks.

The risk-based capital guidelines represent a significant step in the measurement of capital adequacy for several reasons. First, the guidelines strengthen the quality of capital by increasing the emphasis on owned funds and by restricting the amount of loan loss reserves that can be counted as capital. Second, the guidelines recognize the relative degree of credit risk associated with various assets by setting different capital requirements for some assets that clearly have less credit risk than others. Third, banks are required to hold capital against their off-balance sheet activities in a systematic

manner. Fourth, the guidelines will aid in making the definition of capital and the minimum standards uniform internationally.

It should be emphasized that the risk-based capital guidelines establish a minimum capital ratio, and that most banks will be expected to maintain a capital ratio that is above the minimum. The primary focus of the risk-based capital guidelines is credit risk. The guidelines do not explicitly address other types of risk that can affect a bank's condition, such as asset quality, interest-rate risk, asset concentrations, and operational risk. Therefore, the level of capital required for an individual bank will depend on that institution's total risk profile, as determined through the supervisory process.

Risk-Based Capital Ratio

A bank's risk-based capital ratio is calculated by dividing the capital base (numerator) by risk-weighted assets (denominator). Risk-weighted assets include balance sheet assets and off-balance sheet items in proportion to their relative credit risk.

Balance sheet assets are assigned to one of four risk categories--O percent, 20 percent, 50 percent, and 100 percent--based on their relative riskiness. The risk weight is determined by looking at the obligor and, in some cases, the guarantor or the collateral. A full summary of risk-weights and categories is detailed in Section 900.303 of the Appendix to this handbook.

Off-balance sheet items are captured in two steps. First, a credit equivalent is calculated for the off-balance sheet instrument using one of the four credit conversion factors--0, 20, 50, or 100 percent. The appropriate conversion factor is determined by the type of activity. This first step produces a figure that is roughly comparable to the face value of balance sheet assets. The second step assigns the credit equivalent to one of the four risk categories using the same criteria as balance sheet assets--obligor, guarantor, or collateral--to come up with a risk-weighted value like that for balance sheet assets.

Collateral and Guarantees

Only certain types of collateral held by the bank reduce the risk-weighting of the related asset. Similarly, only certain types of guarantees qualify an asset for a lower risk weight.

One important distinction is made with regard to the guarantees of central governments and its agencies. To receive a 0 percent risk weight, the guarantee must be unconditional. A conditional guarantee requires certain affirmative actions, usually servicing standards, to maintain the validity of the guarantee. This distinction only applies to central government guarantees that would otherwise merit a 0 percent risk-weight and, therefore, require no capital to be held against those assets.

Definition of Capital

Under the guidelines, capital is divided into two tiers. Core Capital (Tier 1) is defined as the sum of core capital components, less goodwill and other non-qualifying intangibles. Tier 1 includes the purest and most stable forms of capital—owned funds, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.

Supplementary (Tier 2) capital includes all cumulative perpetual and limited-life preferred stock, hybrid capital instruments, including mandatory convertible securities, term debt, and the reserve for loan and lease losses (RLLL), subject to certain limitations.

Under the guidelines, Tier 2 capital in excess of 100 percent of Tier 1 capital may not be applied to meet the regulatory minimums. This fundamental feature emphasizes Tier 1 capital in the adequacy

determination. There are other limits applied to certain Tier 2 elements; for example, the RLLL can be included as capital only up to 1.25 percent of total risk-weighted assets. This limitation ensures that most of a bank's reserves that are already earmarked to cover likely losses are excluded from capital. Further, to guard against over-reliance on nonperpetual capital, the sum of term debt and intermediate- term preferred stock may be included only up to a total of 50 percent of Tier 1 capital. Moreover, limited-life capital instruments must be amortized over the last five years of their term.

Deductions from Capital

In calculating a risk-based capital ratio, certain items are deducted from the appropriate portion of a bank's capital base to derive the numerator. Goodwill is deducted from Tier 1 capital.

Most other identifiable intangible assets are also deducted from Tier 1 capital unless they satisfy guideline criteria relating to severability, marketability, and demonstrable market values based on identifiable cash flows. Identifiable intangibles, such as purchased mortgage servicing rights, that satisfy the criteria may remain in the bank's Tier 1 capital provided in the aggregate they do not exceed 25 percent of Tier 1 capital.

In addition, investments in unconsolidated banking and finance subsidiaries and international reciprocal holdings of capital instruments of other banking organizations are deducted from total capital.

The 8 percent risk-based capital ratio is a minimum, and most banks will be expected to maintain risk-based capital levels that exceed the 8 percent minimum. This ratio is considered a minimum because, although the risk-based capital standard focuses primarily on credit risk, a bank's capital base must also be available to absorb losses stemming from other types of risk. Therefore, the CBI will continue to assess both the quality of risk management systems and the level of overall risk in individual banks through the supervisory process and will require additional capital when warranted.

An assessment of overall capital adequacy takes into account these and other risks and involves a qualitative judgment made in conjunction with the CBI's supervision of banks. This assessment involves analysis of the quality and level of earnings, the quality of loans and investments, the effectiveness of loan and investment policies, and management's overall ability to monitor and control risk. Thus, the assessment of a bank’s capital adequacy goes far beyond a simple risk-based capital ratio. Nevertheless, the risk-based ratio provides bankers and examiners an important benchmark or starting point for analysis of capital adequacy.

Qualitative Factors

Although the risk-based capital ratio is an important quantitative tool in measuring and regulating capital adequacy, there are numerous qualitative risk factors that must be considered. The CBI recognizes that banks are exposed to varying degrees and types of risk, therefore any comprehensive capital-adequacy determination must be made on a case-by-case basis.

Some of the more important qualitative factors affecting capital are explained below. Supervisory evaluations of capital adequacy should take into account the influence these factors may have on a particular bank:

- *Quality of Management*--The quality, experience, depth, and sophistication of bank management is perhaps most significant in determining capital adequacy. Sound management entails implementing and monitoring policies and procedures, internal controls, and audit coverage. The absence of strong supervision, because of inept or dishonest management, will ultimately lead to a deterioration of bank capital.

- *Funds Management*--Funds management is the core of sound bank planning and financial management. It includes the supervision of bank liquidity and interest rate sensitivity. Each bank should have procedures to minimize the possibility of liquidity risk that could result in forced asset sales or interest rate risk that could result from asset maturities that are mismatched with source fund maturities.

- *Earnings and Their Retention*--A bank's current and historical earnings is another key element in assessing capital adequacy. Good earnings' performance enables a bank to expand, remain competitive, and augment its capital funds. The bank's dividend policy is also of importance. Excessive dividends can weaken a bank's capital position. A history of low dividend payments may impede efforts to issue new equity. Banks located in rapidly growing markets must be attentive to their rate of earnings' retention so they may properly plan for new capital funds as needed.

- *Asset Quality*--The risk-weighting of assets under the Risk-Based Capital Guidelines accounts for the relative credit risk of different instruments. However, the guidelines cannot account for weak or valueless assets held by a financial institution. Lower quality assets have a greater potential for loss and should be reflected in a stronger capital base.

- *Risk Diversification*--Generally, a greater degree of defined asset and liability concentrations increases the need for capital in most banks. On- and off-balance sheet assets should be reviewed for concentrations in industries, product lines, customer types, funding sources, and nonbank activities.

- *Ownership*--The objectives and financial status of a bank's ownership are important considerations since they can significantly affect the condition and direction of a bank. This influence usually is more pronounced when ownership is concentrated. Typically, financially distressed or self-serving ownership will erode capital adequacy over a period of time. Conversely, a very conservative philosophy may be detrimental in the face of progressive competition.

- *Operating Procedures and Controls*--Inefficient or lax operations are costly to a bank. Shortcomings in systems, procedures, and controls expose a bank to loss through fraud, defalcation, or employee error.

- *Strategic Planning*--A dynamic planning process is essential in light of the intense competition within the financial services industry. Banks that identify potential changes in their environment or operations may soon find their financial viability in question.

Banks subject to greater risks include newly chartered institutions, banks receiving special supervisory attention, those experiencing rapid growth, or banks which may be affected through activities of its subsidiaries and affiliates.

Capital Accounts

In addition to determining the adequacy of capital, the examination of capital accounts entails a review and analysis of changes which have occurred or are contemplated, including those in ownership of bank stock. Accounts the examiner reviewing capital will examine are those included in the CBI's definition of capital, except for the reserve for loan and lease losses and subordinated notes and debentures.

Records detailing the number of shares authorized, issued, unissued, and the par value for each class of stock should be maintained in the working papers. Changes in these items should be investigated to determine that necessary approvals have been obtained as required.

Various statutory limitations imposed on banks are determined by the amount of the capital accounts. Testing for compliance with those limitations may necessitate calculating several limits. The examiner performing this program computes all capital-based limits applicable to a bank and distributes the results to appropriate examining personnel.

The examiner must be concerned with the ownership of the bank because shareholders directly influence its course through their election of directors. When a bank is owned or controlled by one person or a small group, the impact is obvious. With cumulative voting of stock, however, a shareholder who owns less than a controlling interest may still be able to elect one or more directors and thus significantly affect the direction of the bank. Generally, the identity of any shareholder or group who owns or controls five percent or more of any class of stock should become a part of the examiner's records. The method by which changes in ownership occur should be reviewed and analyzed for all banks. In banks that have actively traded stock, market acceptance of that stock may be a good indicator of the financial community's attitude toward the institution. In a bank that has a predominantly local market for its stock, information on local residents' interest in purchasing the bank's stock can prove to be beneficial.

In banks that do not have an established market for their stock, an officer or director may find a buyer for the stock of shareholders who wish to sell. A person who provides that service must avoid using insider information in any transaction. One way to eliminate the possibility of a conflict of interest or the use of insider information is for the bank to maintain a list of people interested in purchasing stock. Any prospective seller can then examine the list and sell to an interested buyer at a mutually agreed upon price.

Dividends

Dividends are distributions of earnings to owners. Although dividends usually are declared and paid in either cash or stock, occasionally they are used to distribute real or personal property of value.

Declaration of a dividend requires formal action by the board of directors to designate the medium of payment, the dividend rate, the shareholder record date, and date of payment. Dividends should be recorded as a liability when declared.

Stock dividends are distributions of additional shares to stockholders in proportion to the number of shares they own. They must be reported by transferring an amount equal to the fair value of the additional shares issued to a category of permanent capitalization. The amount transferred may not be less than the par or stated value of the additional shares being issued.

EXAMINATION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding capital accounts and dividends are adequate.

2. To determine if bank officers and employees are operating in conformance with the established guidelines.

3. To evaluate the propriety and consistency of the bank's present and planned level of capitalization and dividend policy in light of existing conditions and future plans.

4. To determine the scope and adequacy of the audit function.

5. To determine compliance with laws, rulings, and regulations.

6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws, rulings, or regulations have been noted.

EXAMINATION PROCEDURES

1. Complete or update the Capital Accounts and Dividends section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls and the work performed by internal/external auditors (see separate program), determine the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal and External Audits," and determine if appropriate corrections have been made.

4. Perform appropriate verification procedures.

5. Update capital account working papers to examination date, and reconcile consolidated balances of the following accounts to the general ledger:

    a. Preferred stock, including limited life preferred stock.

    b. Owned funds.

    c. Valuation reserves for securities.

    d. Reserves for contingencies.

    e. Other accounts representing segregations of capital.

    f. Mandatory convertible instruments.

6. Review accounts for any unusual items and fluctuations between examinations.

7. Obtain the outstanding balance of the reserve for loan and lease losses and balance of subordinated notes and debentures, and calculate the following limits and distribute them to the examiners assigned the appropriate areas:

    a. Large loans.

    b. Loans granted to debtors in special relation with a bank.

8. If any change has occurred in preferred stock, common stock, or authorized but unissued stock:

    a. Notify the examiner assigned "Duties and Responsibilities of Directors."

    b. Determine that any conversion of preferred stock or debt instrument complied with terms of agreement.

9. Insure that entries to owned funds are limited to:

    a. Closing of income and expense.

    b. Payment of dividends.

c. Increases or decreases due to consolidations or mergers.

d. Extraordinary items not normally included in the income and expense account (such items are expected to be rare).

e. Authorized transfers to or from contingency reserve accounts.

10. Determine that a full and correct list of the names and residences of all shareholders and the number of shares held by each is maintained, and that such list is available to all shareholders and creditors of the bank.

11. When a change has occurred in the outstanding voting stock that results in a change in control of the bank, determine that:

    a. Prior notice was given to the CBI and the change was approved. Notice requirements are contained in the rule.

    b. The change was effected according to the specified terms.

12. Update working papers with information regarding the stock holdings of directors, their families, and beneficial interests. Prepare listing of major shareholders, percentage of ownership and affiliations with the bank, and a comment in appropriate report form on the ownership of the bank.

13. If dividends were paid since the last examination:

    a. Ascertain that all preferred stock dividend requirements are met before any dividends are paid to common shareholders.

    b. Verify that no dividends have been paid that constitutes a violation of law or regulation.

14. Prepare or update historical trends of the bank's stock market prices listing highs and lows on a quarterly basis and end-of-period quotes with related price/earning ratios over the last several quarters and analyze any significant trends. When the stock is unlisted and the market for the stock is maintained by the chief executive officer and board members, the examiner should:

    a. Determine who quotes the price and how the price is determined.

    b. Review transactions, and determine if any favorable sales and purchases involve insiders.

    c. Determine whether the bank maintains a list of individuals who have expressed an interest in the stock and, if so, insure that the list of prospective purchasers is available to any shareholder interested in selling stock.

    d. Determine whether stock is selling at a reasonable multiple of earnings.

15. Determine, through review of excerpts of minutes of meetings of the board of directors, if a public or private offering of bank stock or subordinated notes or debentures is being considered. If so, determine that management is cognizant of the bank's potential acceptance into the capital markets. In this regard, also determine that management is fully aware of:

    a. Underwriting expenses.

b. Dilution of shareholder interests, if any.

c. Potential purchaser's aspirations regarding control.

d. Cost of increasing shareholders' equity versus debt equity obligations.

e. Net effect convertible instruments will have on capital accounts.

16. Prepare a summary of the results of the examination procedures performed to this point, noting any deficiencies, which have been disclosed.

17. The examiner-in-charge, when performing the review processes necessary in "Overall Conclusions Regarding Condition of the Bank," evaluates the propriety and consistency of the bank's present and planned level of capitalization in light of existing conditions and future plans. In this regard, the examiner assigned the "Capital Accounts and Dividends" program should:

    a. Analyze applicable ratios involving capital funds, comparing them with those of other comparative banks and investigating trends or significant variations from group averages.

    b. Determine that capital is sufficient to compensate for any instabilities or deficiencies in asset and liability mix and quality mentioned in "Funds Management."

    c. Analyze present and projected dividends to determine if they are considered excessive. If excessive, analyze the resulting sacrifice to capital, particularly if such dividends were or are to be paid to encourage the success of an equity offering.

    d. Determine if the bank's earnings performance enables it to fund its expansion adequately, to remain competitive in the market, and to replenish and/or increase its capital funds as needed.

    e. Analyze the bank's present and projected deposit and borrowed funds structure to determine that present and projected capital is sufficient to maintain depositor and lender confidence.

    f. If the reserve for loan and lease losses is determined to be inadequate, analyze the impact of current and potential losses on the bank's capital structure.

    g. Determine if shortcomings in internal controls and audit procedures will make the bank more susceptible to loss through fraud and defalcation and thereby weaken the capital base.

    h. Consider the impact of any management deficiencies on present and projected capital adequacy.

    i. Determine that there are no other assets or contingent accounts whose quality represents an actual or potentially serious weakening of capital.

    j. Consider the potential impact of any proposed changes in controlling ownership on the projected capital position.

18. In light of the analysis conducted in step 17, and in accordance with the CBI's minimum capital ratios, determine the appropriate supervisory action as it relates to the bank's capital adequacy.

19. Review the following items with appropriate management:

    a. All deficiencies noted with respect to the capital accounts and dividends.

    b. Adequacy of present and projected capital.

20. Prepare comments for the examination report on the bank's capital and dividend posture, and include any deficiencies reviewed with management and any remedial action recommended.

21. Prepare a memorandum, and update work programs with any information, which will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures for capital accounts and dividends. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with asterisks (*) require substantiation by observation or testing.

General

1. Does the bank employ the services of an independent stock registrar, stock transfer agent, and dividend paying agent?

2. Does the bank prepare periodic analysis of its capital position with respect to both current and future needs?

3. (*) Has the board of directors passed a resolution designating those officers who are authorized to:

   天 Sign stock certificates?

   天 Maintain custody of unissued stock certificates?

   天 Sign dividend checks?

   天 Maintain stock journals and records?

4. (*) Are capital transactions independently verified before stock certificates are issued?

5. (*) Are persons responsible for the handling of stock certificates and debentures different from those responsible for recording those transactions?

6. (*) Does the bank maintain a stock certificate book with certificates serially numbered by the printer?

7. (*) Is the stock certificate book maintained under dual control?

8. (*) Does the bank's policy prohibit the signing of blank stock certificates?

9. Does the bank maintain a shareholders' ledger, which reflects the total number of shares owned by each stockholder?

10. Does the bank maintain a stock transfer journal disclosing names, dates, and amounts of transactions?

11. (*) Are surrendered stock certificates canceled?

12. (*) Are unused dividend checks under dual control?

13. (*) Does the bank's system require separation of duties regarding custody, authorization, preparation, signing, and distribution of dividend checks?

14. Are dividend checks reconciled in detail before mailing?

15. Is control maintained over the use of serially numbered dividend checks to insure they are issued sequentially?

Conclusion

16. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

17. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____(good, medium, or bad).

VERIFICATION PROCEDURES

Capital Stock

1. If the bank has an outside transfer agent and/or registrar:

    a. Request confirmation from transfer agent of total shares issued.

    b. Request confirmation from registrar of the total shares authorized and total shares issued.

    c. Check information confirmed by transfer agent and registrar.

2. If the bank acts as its own transfer agent and/or registrar:

    a. Verify outstanding stock by reference to open stubs in stock certificate book.

    b. Obtain or prepare a working paper listing transactions since the preceding examination to include new shareholder's name, number of shares, and certificate number offsetting with prior shareholder's name(s), number of shares surrendered, and certificate number(s).

    c. Account for all unissued stock certificates.

    d. Ascertain that surrendered, misprinted, and mutilated certificates have been effectively canceled and accounted for.

3. Total stockholder ledgers, and reconcile total par value of each class of stock issued and outstanding to the analysis obtained in step 1 and to the appropriate general ledger control accounts.

4. For capital changes since the previous examination:

    a. Reconcile the proceeds of capital stock sold to investment bankers' statements, prospectuses, option agreements, etc., and trace credit to the general ledger.

    b. Check disbursements (payments to underwriters, etc.) in connection with the stock sale to contracts, official approvals, or invoices.

Dividends

1. Check the computation of dividends paid by multiplying the number of shares outstanding at each dividend date by the appropriate per share amounts approved by the board of directors.

2. Review and document, by memorandum, the flow of dividends from authorization to payment, and determine that the liability added immediately after declaration of any dividend is equal in amount to the cash dividend declared.

3. Obtain a schedule of any cumulative preferred dividends in arrears.

4. Review and determine the propriety of handling of unclaimed dividend checks.

Translated from Arabic

INTRODUCTION

This section is designed to assist the examiner in forming a comprehensive understanding of the financial conditions and results of the bank's operations trough an analytical review. It also provides procedures to assist in assessing the veracity and credibility of income and expenses of the bank. The general understanding of the balance sheet, income and expenses accounts is very important to analyze effectively the earnings performance. Therefore, Examiners should review the financial and income reports of the bank ahead of time or while performing the review (balance sheet, income and expenses accounts).

Overview:

The review and analysis of the financial conditions and results of the banks must begin during the initial review of the bank operations by using the latest available financial reports. The purpose of this review is to define the potential problems, to properly determine the scope of the examination, to ensure the availability of a suitable work team and to establish appropriate review procedures.

The review must also answer the questions that come to light during the initial examination and ascertain their legitimacy in consideration of regulatory procedures, while doing the comprehensive analytical review of the bank's profits.

The analytical review will be performed using different sources of information. The most important sources include: financial statements of the bank, general ledger, income statement, financial balances, basic assumptions, management information system, (all official reports prepared for the board of directors or the senior management, informal reports and official reports presented to Iraqi Monetary Authority). The information in the books, journal and general ledger will provide reliable and detailed information in case of unusual or exceptional situations during the review process. The work that has been done to understand these unusual or extraordinary items must be documented.

In some cases, the review and checking procedures for income and expenses may be implemented by examiners assigned to other areas. For example checking the income from interests according to the procedures that have been described in sections for loans procedures or the "securities investment". The repairs and maintenance expenses may be examined under "bank's buildings and equipment". Interest expenses, income from service fees may be examined under "deposits accounts". Interest related to borrowed funds maybe examined under" borrowed money".

The examiner may want to perform the verification of the procedures set forth in the above sections if the income and expenses accounts are not to examined by other employees or by the bank's internal or external auditors.

The analytical review includes detailed comparison of balances or statistical data in accordance to the "One period to another" rule and the in depth verification of the credibility of the operations, which include un-checked accounts balances. The analytical review is based on the assumption that the accuracy in the balances and ratios make this review appear without serious errors. The good execution of the analytical review is not only useful for examination purposes by providing a good understanding of the bank's operations, but it also shows issues

concerning the interest position and potential problems, which if noticed at an early stage, could prevent a lot of dangerous problems. The basic analytical tools available to the examiner are the office analysis reports and the financial statements of the bank. Internally prepared statements and supplementary schedules, if available, strengthen in-depth review. The information from those documents may give the examiner considerable insight into the interpretation of the bank's basic financial statements. Internally prepared information is not in itself sufficient to adequately analyze the financial condition of the bank. To properly understand and interpret financial and statistical data, the examiner should be familiar with current national, regional and local economic and industry conditions, and any secular, cyclical or seasonal factors. Current knowledge of such conditions and factors by reviewing appropriate economic and industry information such as that available in newspapers and industrial journals is important to the examiner in adequately reviewing and analyzing a bank.

An analytical review of a bank's financial statements requires professional judgment, imagination and discrimination. Examiners should avoid details that may superficially relate to their objectives. It is important to maintain a sense of proportion when analyzing the statements and avoid spending excessive time on relatively immaterial amounts.

Generally, the most efficient manner for reviewing the financial statements is to round the figures to the thousands. Excessive accuracy when calculating and reviewing the ratios must be avoided. It is important to compare numbers and percentage, as it does not mean anything to simply calculate the ratios of totally different items. When comparing the data of the bank under review with the data of peer group, the examiner should take into consideration the similarities of the bank to its peer group (peer group means: group of banks that have comparable volume of assets and reporting systems). For example, a bank maybe similar to its group in term of size but has profit-generating assets consisting mainly of agricultural or mortgage loans, which maybe totally different from that of the bank under review. Different audit for similar operations must be considered because it may result in different results. The consistency in different applications in one bank is very important. Therefore, the examiner should determine during the review any inconsistency that may have a material effect in the application of accounting principles

The various reports and the analysis performed during the audit process are the main tools available to the examiner for the analytical review. The most important information sources used in the preparation of the analysis are the official report classified according to a system that indicates the financial conditions and the income. In certain circumstances the examiner may be interested in the current and detailed audit reports of the bank, more than by the details of the information provided. For example, some of these situations may occur because:

- The volume of information such as the number of demand-deposit accounts, certificates of deposit and other accounts, which are not included in the reports. It is also customary to take into consideration the exposure of the bank to risk concentration.
- The components of interest and fees on loans, which are computed separately according to the loans classification, may not show the adverse trends in the loans portfolio. For example, the return shown on the ledger for certain a category of loans is increasing, but this upward trend is compensated by a downward trend in another category. In spite of that the bank will remain sound, but the examiner should check the conditions that apply to each type of loans. The management of

banking supervision may ask for this kind of analysis because of the changing circumstances observed by the financial analyst.

- Expenses and revenues generated by new operations and business that are not distinct from those resulting from existing operations as shown in the financial information. The examiner may wish to analyze its future effect on the bank's operations when there is significant diversifying of activity.
- Amounts considered may not be important, but reviewing the “Net” numbers may reveal cases that need further scrutiny. For example, the balance between profits and losses of securities. The net results in the report maybe very small and un important, though the components of the operations are very large. In this case the examiner needs verifying the reason for this situation and the nature of the transactions.
- The examiner should be attentive at all time to unusual transactions, which may indicate fraudulent or illegal activities by top executives, members of the Board of Directors or insiders.

Analytical review is a valuable tool that must be completed and followed up by a more in-depth analysis in order to achieve a clear understanding of the quality of bank revenues and of their consistency.

After the completion of the analytical review of the bank, the examiner must have a good knowledge of the financial position and results from operations. This knowledge is an essential element for the appropriate and successful completion of the examination process.

EXAMINATION OBJECTIVES

1. To detect significantly changed circumstances before or as early as possible during the examination so that any impact on the determination of the scope and conduct of the examination may be assessed.

2. To analyze the financial position and operations of the bank and to investigate any unusual fluctuations.

3. To assist in determining the reliability of the bank's financial information and the consistency of the application of accounting principles.

4. To determine if accounting policies, practices, procedures, and internal controls relating to income and expenses are adequate.

5. To determine the scope and adequacy of the audit function.

6. To determine compliance with laws and regulations relating to income and expenses to the extent that such compliance is not covered elsewhere in the examination.

7. To initiate corrective action when deficiencies or violations of law or regulation have been discovered.

EXAMINATION PROCEDURES

1. Analyze net interest income.

- Compare the bank's net interest income, as a percentage of average assets, with its peer group. Determine whether any difference is caused primarily by a difference in the spread or by a difference in the net interest position.

- Discuss recent changes in the spread between the rate of return on interest-earning assets and the rate of payment on interest-costing liabilities. Compare the bank's spread with the peer group and determine whether the difference is due to a difference in the rate of return on interest-earning assets, a difference in the rate of payment on interest-costing liabilities, or both.

- Analyze the rate of return on interest-earning assets.

    1. Comment on the change in the rate of return from the previous reporting period and on any longer-term trend that may be apparent from the data. Determine if anything other than a change in market interest rates, such as a change in the mix of assets, contributed to the change in the rate of return.

    2. Compare the bank's rate of return on assets with the peer group. Determine whether the difference, if any, is caused by differences in the mix of assets or by different rates of return on the various types of assets. Determine whether the bank's assets are, in general, of longer or shorter maturity than those of the peer group and if that may help explain the difference.

- Analyze the rate of payment on interest-costing liabilities.

    1. Comment on the change in the rate of payment on interest-costing liabilities from the previous reporting period and on any longer-term trend that may be apparent from the data. Determine if anything other than a change in market interest rates, such as a change in the mix of liabilities, contributed to the change in the rate of payment on interest-costing liabilities.

    2. Compare the bank's rate of payment on interest-costing liabilities with the peer group. Determine whether the difference, if any, is caused by differences in the mix of liabilities or by different yields on the various types of liabilities. Determine whether the bank's liabilities are, in general, of longer or shorter maturity than those of the peer group and if that may help explain the difference in rate of payment on interest-costing liabilities.

    3. If the bank is paying higher interest rates on its deposits or other liabilities than similar banks are paying, determine the reasons for the difference (rapid growth, difficulty in obtaining deposits, etc.).

- Use the maturity schedule of the bank's financial report to determine if the bank's spread would likely increase or decrease if market interest rates increased or decreased.

- Use the schedule of net financial assets denominated in foreign currencies to determine if the bank's spread would likely increase or decrease if foreign exchange rates increased or decreased.

- Compare the bank's net interest position with the peer group. Comment on the reasons for any relative weakness (low capital, high amount of non-performing assets, etc.).

2. Compare the bank's fee income with the peer group and describe any observable trends.

3. Analyze the bank's profit from financial operations.

- Call the bank for an explanation of any unusually high profit or loss.
- Compare the bank's profit from financial operations with the peer group.
- Determine whether this source of profit is relatively stable or whether it fluctuates greatly from quarter to quarter. If it fluctuates, compute the average profit earned over the last several quarters and compare that with the peer group.

4. Analyze administrative expense.

- Compare the bank's ratio of administrative expense to average assets to the peer group and describe any observable trends. If administrative expense is abnormally high, determine if the bank is involved in high-cost activities to a greater extent than is typical. These activities include demand deposits and services that generate fee income.
- Compare the bank's efficiency ratio to the peer group.
- If administrative expense is high, compare the major components of administrative expense, as percentages of total assets, to the peer group to determine which component is abnormal.
- If total personnel compensation and expense is high, determine if the cause is abnormally high salaries or an abnormally high number of employees.

5. Compare the bank's ratio of net operating income to average assets to the peer group and describe any observable trends. Summarize the main causes of an abnormally high or low net operating income.

6. Analyze loan and lease loss expense.

- Compare the bank's ratio of this expense to average assets to the peer group and describe any observable trends. Do this comparison for the current financial reporting period and for an average of the previous four or five periods.
- Comment on whether the bank has recorded losses in excess of existing reserves.
- Using your analysis of asset quality, make a statement about whether loan and lease loss expense is likely to increase or decrease in the near future.

7. Comment on whether net operating income exceeds or falls short of loan and lease loss expense.

8. Review the net gain (loss) on the sale of assets, the gain (loss) on the net monetary position, the gain (loss) on the net foreign currency position, extraordinary items, and income taxes for signs of unusual activity.

9. Compare the bank's return on average assets with the peer group and describe any observable trends. Briefly summarize why the bank's profitability is abnormally high, normal, or abnormally low.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices and procedures over income and expenses. The bank's system should be documented in a complete and consistent manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk (*) require substantiation by observation or testing.

Generals

1. Does the bank have a budget? If so:

   a. Is it reviewed and approved by managerial personnel and/or the board of directors?
   b. Is it periodically reviewed and updated for changed conditions?
   c. Are periodic statements compared to budget and are explanations of variances reviewed by management?
   d. Is a separate budget prepared by the manager of each department or division?

2. Does the bank's accounting system provide sufficiently detailed breakdowns of accounts to enable it to analyze fluctuations?

3. *Are the general books of the bank maintained by someone who does not have access to cash?

4. Are all general ledger entries processed through the proof department?

5. Are all entries to the general ledger supported by a general ledger ticket?

6. Do general ledger tickets, both debit and credit, bear complete approvals, descriptions and an indication of the offset?

7. *Are all general ledger entries approved by a responsible person other than the general ledger bookkeeper or person associated with its preparation?

8. Is the general ledger posted daily?

9. Is a daily statement of condition prepared?

10. *Are corrections to ledgers made by posting a correcting entry and not by erasing (manual system) or deleting (computerized system) the incorrect entry?

11. Are supporting worksheets or other records maintained on accrued expenses and taxes?

12. Are those supporting records periodically reconciled with the appropriate general ledger controls?

Purchases

13. *If the bank has a separate purchasing department, is it independent of the accounting and receiving departments?

14. *Are purchases made only on the basis of requisitions signed by authorized individuals?

15. *Are all purchases routed through a purchasing department or personnel functioning in that capacity?

16. Are all purchases made by means of pre-numbered purchase orders sent to vendors?

17. Are all invoices received checked against purchase orders and receiving reports?

18. Are all invoices tested for clerical accuracy?

19. Are all invoice amounts credited to their respective accounts and tested periodically for accuracy?

Disbursements

20. *Is the payment for all purchases, except minor items, made by official checks?

21. *Does the official signing the check review all supporting documents?

22. *Are supporting vouchers and invoices cancelled to prevent re-use?

23. *Are duties and responsibilities in the following areas segregated?

    a. Authorization to issue expense checks?
    b. Preparation of expense checks?
    c. Signing of expense checks?
    d. Sending of expense checks?
    e. Use and storage of facsimile signatures?
    f. General ledge posting?
    g. Subsidiary ledger posting?

Payroll

24. Is the payroll department separate from the personnel department?

25. Are signed authorizations on file for al payroll deductions for withholding?

26. Are salaries authorized by the board of directors or its designated committee?

27. Are individual wage rates authorized in writing by an authorized officer?

28. Are vacation and sick leave payments fixed or authorized?

29. Are payrolls paid from a special bank account or directly credited to the employee's demand deposit account?

30. Are time records reviewed and signed by the employee's supervisor?

31. Are double checks made of hours, rates, deductions, extension, and footings?

32. Are payroll signers independent of the persons approving hours worked and preparation of the payroll?

33. If a check signing machine is used, are controls over its use adequate (such as a dual control)?

34. Are payrolls subject to final officer approval?

35. Are the names of persons leaving employment of the bank reported promptly, in writing, to the payroll department?

36. Are payroll expense distributions reconciled with the general payroll payment records?

Conclusion

37. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

38. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate, inadequate).

Translated from Arabic

Verification procedures

1) For important income and expenses accounts for which the verification procedures have not been done anywhere else:

a- be prepared to analyze such accounts for the period since the last examination process, preferably computed on a monthly basis. Any unusual fluctuations should be noted and explained

b- Get a clarification of the important variations and extraordinary items that were found, through discussion with the staff of the bank, and review the supporting documents.

2) For income accounts that did not get a complete explanation during in the first examination stage, use appropriate sampling technique for the examination, as follows:

- select the special operations in income accounts, from the main documents of examination.
- check the computation of recorded accounts, and follow the process from the successive records to the transfer to the general ledger.
- check the sum in general ledger to verify the accuracy of the balance.

3) For expense accounts that did not get a complete explanation during in the first examination stage, use appropriate sampling technique for the examination, as follows:

- look at the carryover of accounts to the general ledger, and at the same time examine the sum of he accounts.
- track the values and the amounts in successive records.
- examine the supporting documentation of the process and verify the calculation process that is reflected in these documents.

INTRODUCTION

Funds management represents the core of sound financial planning. Although it is not a new concept; practices, techniques, and norms have been revised substantially in recent years. Funds management is the process of managing balance sheet and off-balance sheet instruments to maximize and maintain the spread between interest earned and paid while ensuring the bank's ability to pay off liabilities and fund asset growth. Therefore, a bank's funds management practices will affect earnings and liquidity.

A sound basis for evaluating funds management is by understanding the bank, the customer mix, the asset and liability composition, and the economic and competitive environment. The adequacy of policies, procedures, and management information systems must be determined, and the effect of funds management practices on liquidity and interest rate risk analyzed. Liquidity risk is related to, but substantially different from, interest rate risk. Liquidity risk arises from mismatching the maturities of assets and liabilities. Interest rate risk arises from mismatching the repricing of assets and liabilities. Both risks may be increased by rumored or existing asset quality deterioration. Poor asset quality will introduce maturity mismatches through assets failing to pay off as agreed, or repricing mismatches through the borrower's inability to pay higher rates on variable rate loans. Rumored asset problems may cause a run on deposits, which, in turn, will result in both maturity and price mismatches.

Liquidity

Liquidity represents the ability to accommodate decreases in deposits and other purchased liabilities, and fund increases in assets. Funds must be available at reasonable prices relative to competitors, and in maturities required to support prudently medium to longer term assets. Liquidity is essential in all banks to compensate for expected and unexpected balance sheet fluctuations and to provide funds for growth.

The cost of liquidity is a function of market conditions and the degree of risk, both interest and credit, reflected in the bank's balance sheet. If liquidity needs are met through holdings of high quality liquid assets, the cost becomes the income sacrificed by not holding higher yielding long term and/or lower quality assets. If liquidity needs are not met through liquid asset holdings, a bank may be forced to acquire additional funds under adverse market conditions at excessively high rates. In large banks, however, maturing assets or their liquidation do not provide assured liquidity continuously. In those banks, asset liquidity is supplemented by the ability to roll over maturing liabilities and acquire new ones daily.

The adequacy of a bank's liquidity will vary from bank to bank. In the same bank, at different times, similar liquidity positions may be adequate or inadequate depending on anticipated need for funds. In addition, a liquidity position which is adequate for one bank may be insufficient for another bank. Determining the adequacy of a bank's liquidity position depends upon an analysis of the bank's:

- Present and anticipated asset quality.
- Present and future earnings capacity.
- Historical funding requirements.
- Current liquidity position.
- Anticipated future funding needs.
- Options for reducing funding needs or attracting additional funds.
- Sources of funds.

To provide funds to satisfy liquidity needs, a bank must perform one or a combination of the following:

- Dispose of liquid assets.
- Increase short-term borrowing (and/or issue additional short-term deposit liabilities).
- Decrease holdings of nonliquid assets.
- Increase liabilities of a term nature.
- Increase capital funds.

Forecasting future events is essential to liquidity planning. Management must consider the effect those events are likely to have on funding requirements. If management does not consider future events and plan the bank's funding strategy accordingly, the bank will be run by the dictates of the economy rather than by management. All banks are affected by changes in the economic climate. However, sound financial management can buffer negative changes and accentuate positive ones.

Information that management should consider in liquidity planning includes:

- Economic forecasts.
- Internal costs of funds.
- Mismatches in the balance sheet.
- Interest rate forecasts.
- Anticipated funding needs.

Management also must have contingency plans in case its projections are wrong. Effective contingency planning involves identifying minimum and maximum liquidity needs and weighing alternative courses of action designed to meet them.

Contingencies that may affect a bank's liquidity include:

- New business opportunities.
- Acquisitions.
- New management.
- Earnings decline.
- Nonperforming asset increase.
- Downgrading of the acceptability of the banks stock by the market.

Once liquidity needs have been determined, management must decide how to meet them through such methods as asset management, liability management, or a combination of both.

Asset Management

Liquidity needs may be met by manipulating the bank's asset structure through the sale or planned runoff of a reserve of readily marketable (liquid) assets. Many banks, particularly the smaller ones, tend to have little influence over the size of their total liabilities. Such banks rely on liquid assets to fund increases in trade area loan demand. Banks which rely solely on asset management concentrate on adjusting the price and availability of credit, and the level of liquid assets held in response to changes in customer asset and liability preferences.

The amount of liquid assets a bank should hold depends on the stability of its deposit structure and the potential for rapid loan portfolio expansion. Generally, if deposit accounts are composed primarily of small stable accounts, a relatively low allowance for liquidity is necessary. A higher allowance for liquidity is required when:

- Recent trends show substantial reduction in large accounts.

- 天 Substantial deposits are short-term government special assessment-type accounts.
- 天 A substantial portion of the loan portfolio consists of large static loans with little likelihood of reduction.
- 天 Large unused lines of credit or commitments to lend are expected to be used immediately.
- 天 Concentration of credits have been extended to an industry with present or anticipated financial problems.
- 天 A strong relationship exists between individual demand accounts and principal employers in the trade area who have financial problems.

Asset liquidity, or how "salable" the bank's assets are in terms of both time and cost, is of primary importance in asset management. Liquid assets provide insurance as well as yield. To maximize profitability, management must carefully weigh the full return on liquid assets (yield plus insurance value) against the higher return associated with less liquid assets. Income derived from higher yielding assets may be offset if a forced sale is necessary because of adverse balance sheet fluctuations.

Assets normally assumed to be liquid, sometimes are not easily liquidated. For example, investment securities may be pledged against public funds and repurchase agreements, or may be depreciated heavily because of interest rate changes. Trading accounts cannot be reduced materially because banks must maintain adequate inventories.

Seasonal, cyclical, or other factors may often cause aggregate outstanding loans and deposits to move in opposite directions and result in loan demand which exceeds available deposit funds. A bank relying strictly on asset management would restrict loan growth to that which could be supported by available deposit funds. As an alternative, liquidity needs may be met through liability sources, such as inter-bank funds purchased, borrowings from the Central Bank, purchased deposits (i.e., brokered deposits), and sale of securities under agreements to repurchase, which would allow the bank to meet the loan demand of its trade area. The decision whether or not to use liability sources should be based on a complete analysis of seasonal, cyclical, and other factors, and the costs involved. In addition to supplementing asset liquidity, liability sources of liquidity may serve as an alternative even when asset sources are available.

Liability Management

Liquidity needs can be met through the discretionary acquisition of funds on the basis of interest rate competition. This does not preclude the option of selling assets to meet needs, and, conceptually, the availability of asset and liability options should result in a lower liquidity maintenance cost. The alternative costs of available discretionary liabilities can be compared to the opportunity cost of selling various assets. The major difference between liquidity in larger banks, as contrasted with smaller banks, is that in addition to deliberately designing the composition of the asset side of the balance sheet, larger banks are better able to control the level and composition of their liabilities. When funds are required, larger banks have a wider variety of options from which to select the least costly method of generating funds. In addition, discretionary access to the money market should reduce the size of the liquid asset "buffer" that would be needed if the bank were solely dependent upon asset management to obtain funds.

The ability to obtain additional liabilities represents liquidity potential. The marginal cost of liquidity, the cost of incremental funds acquired, is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to such factors as the frequency with which the bank must regularly refinance maturing purchased liabilities, as well as an estimate of the bank's ability to obtain funds in the money market. The obvious difficulty in estimating the latter is that, until the bank goes to the market to borrow, it cannot be determined with complete certainty that

funds will be available at a price that will maintain positive yield spread. Changes in money market conditions may cause a rapid deterioration in a bank's capacity to borrow at a profitable rate. In this context, liquidity represents the ability to attract funds in the market when needed, at a reasonable cost.

As previously noted, large bank's access to discretionary funding sources is a function of their position and reputation in the money markets. Although smaller institutions do not have a "name" in those markets, they are not precluded from liability management. The scope and volume of their operations is, however, somewhat limited.

Although the acquisition of funds at a competitive cost has enabled many banks to meet expanding customer loan demand, misuse or improper implementation of liability management can have severe consequences. Examiners should be aware of the following risks associated with the practice of liability management:

- Purchased funds may not always be available when needed. If the market loses confidence in a bank, that bank's liquidity may be threatened.

- Concentrations in funding sources increase liquidity risk. A bank relying heavily on foreign interbank deposits will experience funding problems if foreign markets perceive instability in Iraqi banks or its economy. Replacing foreign sources will be difficult and costly because the domestic market may view the bank's sudden need for funds as a danger signal.

- Over-reliance on liability management may cause a tendency to minimize holdings of short-term securities, relax asset liquidity standards, and result in a large concentration of short-term liabilities supporting assets of longer maturity During times of tight money, this could cause an earnings squeeze and an illiquid condition. Funds employed from liability management should be hedged or placed principally in assets with matching maturities or which have flexible interest rates.

- Due to rate competition, funding costs may increase. In an attempt to offset the increase, a bank may lower credit standards to invest in higher yielding loans and securities. If a bank is purchasing liabilities to support assets that are already on its books, an increase in the cost of purchased funds may result in a negative yield spread.

- When national monetary tightness occurs, interest rate discrimination may develop, making the cost of purchased funds prohibitive.

- Preoccupation with obtaining funds at the lowest possible cost, without considering maturity distribution, greatly intensifies a bank's exposure to the risk of interest rate fluctuations.

In all banks, and particularly in wholesale-funded ones, management must be aware constantly of the composition and characteristics of its funding sources.

Real or rumored deterioration in the financial condition of a bank because of asset quality, fraud, or external economic developments will affect wholesale funding adversely. The extent of that reaction depends on the bank's funding sources and their risk tolerance.

Interest Rate Risk

Interest rate risk arises from the impact that future interest rates will have on a bank's reported earnings and the market value of its portfolio equity.

The risk to a bank's reported earnings arises from a bank's historic cost business and any positions carried on a market valuation basis. Changes in interest rates will effect reported earnings through changes in net interest income and the market value of trading accounts or assets held for resale carried on a market valuation basis.

The risk to the market value of portfolio equity arises primarily from a bank's long-term, fixed rate positions. The value of a fixed rate instrument varies with interest rates. For example, a five-year, fixed rate bond will decline in value if interest rates rise, and a bond with a longer maturity will decline even more with the same rate change. In the same way, the underlying value of a bank can change when interest rates change, and a bank with unmatched, long-term, fixed rate positions is exposed to a sustained adverse interest rate movement. Although these positions may not pose a risk to near term reported earnings due to historic cost accounting conventions, they can expose the bank to substantial interest rate risk and, over time, result in lower reported earnings or general underperformance of the market.

Risk to reported earnings is often referred to as accounting exposure and the risk to market value of portfolio equity as economic exposure. Both exposures are important and should be considered in assessing interest rate risk. The impact on earnings is significant because of the liquidity and capital adequacy consequences that reduced earnings or losses might imply. The impact on market value is significant because it is a measure of a bank’s true capital solvency and a reflection of the net value of a bank upon liquidation or forced sale. This perspective is particularly relevant for regulators because negative changes in the market value of portfolio equity can be a leading indicator of future earnings' problems. In addition, the market value also reflects the true liquidity of bank assets since the cost of selling depreciated assets to meet liquidity needs may be prohibitive.

The introduction of more complex financial products, and increased competitive pressures have accentuated the need for prudent management of interest rate exposures. The margin for error in funds management and pricing decisions has been reduced, and the need for the board and senior management to adopt policies addressing interest rate risk and to implement adequate risk measurement and reporting systems has increased. Components of prudent interest rate risk management include policy statements, risk limits, risk measurement systems, and reports to management and the bank's board of directors.

Specific strategies adopted by banks to compensate for the changing environment include:

- The expansion of variable rate lending.
- The shortening of maturities in the investment portfolio.
- The generation of fees from the packaging and sale of fixed rate, longer term loans.
- The use of interest rate futures, swaps, and other products to hedge against fluctuations in interest rates when an imbalance exists in a bank's rate sensitivity position.
- The development of sources of fee/noninterest income.

When evaluating a bank's interest rate risk exposure, examiners should consider both the level of risk and the quality of risk management. Examiners should base their assessments on a review of policies and operating limits, management structure and practices, risk measurement systems, and the reported and perceived level of risk exposure.

Risk Limits

Repricing imbalances pose various risks to net interest income. A liability sensitive bank is at a disadvantage when interest rates are rising since it will be more costly to fund liabilities that are supporting fixed rate assets. It is difficult to adjust a liability sensitive position to achieve a balanced one without suffering a loss of business. A bank has limited control over the volume of its fixed rate liabilities. Therefore, to achieve balance would likely require a runoff of rate-sensitive liabilities and a reduction in fixed rate, long-term loans or securities supported by those liabilities. This may be difficult since rising rates would indicate the likelihood of a capital loss from the sale of fixed rate assets.

A proper balance between rate sensitive assets and rate sensitive liabilities should help minimize the effect on earnings caused by adverse movement in interest rates. The larger the imbalance, the greater the risk the bank is assuming, and the greater the impact of an adverse rate movement. To control risk, limits should be established for the risk to earnings arising from mismatches between the repricing of assets, liabilities, and off-balance sheet contracts carried on an historic cost basis. Since these "gap" mismatches create exposure to net interest income, limits on gaps are best expressed in terms of net interest income at risk.

Risk limits should also address risk to earnings arising from positions that are carried on a market valuation basis (mark-to-market or lower-of-cost-or-market). This includes trading positions and assets held for resale. Limits on these positions may be expressed in term of the risk to market values.

Limits on earnings exposure should consider potential adverse changes in interest rates rather than anticipated rate movements. Anticipated rate movements may indicate management's expectation of what is likely to happen. Risk limits are designed to control what may happen if outcomes deviate from expectations.

Banks with unmatched, long-term, fixed rate positions are exposed to a sustained adverse interest rate movement. Banks that have such positions should evaluate and limit the severity of these exposures. Typically, these positions arise from mortgage and investment portfolios that are funded short-term.

Rate Risk Measurement Systems

There is wide variation in the techniques used by banks to measure and manage their interest rate exposure, and no one technique is appropriate for all banks. The adequacy of risk measurement systems and the extent of reviews performed to determine management's ability to monitor exposure will depend on the bank's size, complexity, and level of interest rate risk assumption. For example, a smaller bank without significant interest rate exposure might rely on a simple gap report to measure its exposure. A bank that engages heavily in mortgage lending may need a more sophisticated system that captures prepayment risk on fixed rate mortgages. A market valuation assessment may be more valuable in large banks, banks experiencing liquidity problems, or banks with a relatively large volume of long-term, fixed rate assets or liabilities. In general, the risk measurement technique(s) used should capture a bank's significant sources of interest rate exposure.

Gap Reports

The most common tool used to measure rate sensitivity is a point-in-time maturity ladder (gap) report. Gap reports typically are used to measure risk to net interest income arising from instruments carried at historic cost. Differences in the repricing dates of assets, liabilities, and off-balance sheet contracts are a primary component of risk to net interest income. A typical gap report stratifies all current and contracted positions by their respective repricing date. By netting the gross balances, a net repricing imbalance in each time frame is determined. These imbalances indicate the sensitivity of net interest

income to a change in interest rates. The amount of risk depends on the size of the repricing imbalances, how long the imbalances remain open, and potential movements in interest rates.

Net positions in each time frame may be expressed as assets less liabilities, as liabilities less assets, or as the ratio between rate sensitive assets (RSA) and rate sensitive liabilities (RSL). For example, a short funded position (liabilities repricing before assets) would be expressed as a net negative position when period gaps are computed by subtracting repricing liabilities from repricing assets. When using the ratio method, a RSA/RSL ratio of 1 indicates a balanced position and a ratio greater than 1 an asset sensitive bank. A ratio less than 1 indicates a liability sensitive bank.

Many banks, rather than relating repricing imbalances to net interest income at risk, simply limit the size of their gaps. For example, a bank may limit the ratio of rate sensitive assets to rate sensitive liabilities to given range, such as .90 to 1.10. Such limits, by themselves, do not directly identify earnings exposure. A bank that uses such limits, probably made some assumptions about the relationship between gaps and earnings when it established those limits. Expressing limits in terms of net interest income at risk makes those assumptions explicit. Examiners should encourage banks using gap reports to express limits in terms of the account at risk, net interest income.

Gap reports provide a measurement of net interest income at risk and indicate the timing of that risk. They are particularly useful in identifying sources of risk arising from the existing assets, liabilities, and off-balance sheet contracts of a bank.

Gap reports are subject to limitations, however. Indeed, maintaining a balanced position for all time periods in a gap report does not ensure that the bank is immune to interest rate risk. The following cause this apparent contradiction and are the limitations inherent in most gap reports:

- Interest rates do not always move in tandem. The divergence in interest rate movements is referred to as basis risk. A bank that funds a prime-based loan with a short-term CD might not show any exposure for this position in its gap report since both instruments have short maturities. The bank could suffer a decline in earnings, however, if the CD rate has increased at the repricing date but the prime rate has not changed.

- Significant risk may be hidden in the repricing time frames of the gap report. A bank's gap report may show a balanced position for a 90-day period. However, interest rate risk may be significant if most assets reprice at the beginning of the period, most liabilities reprice at the end of the period, and interest rates decrease at the beginning of the period.

- Many retail banking products incorporate options features, which are often referred to as embedded options. Examples of these include prepayments on fixed rate loans, caps on floating rate loans, and early withdrawal rights on deposits. The repricing dates for products with options will vary with interest rates. For example, fixed rate mortgages typically will prepay faster in lower interest rate environments. Embedded options generally work in favor of the customer and against the bank. When prevalent, options can pose significant risk to net interest income, but their effects are not easily incorporated into a gap report. To capture these exposures, some banks will prepare a series of gap reports for different levels of interest rates. A gap report for a low rate environment may show shorter maturities for mortgage loans, reflecting higher prepayments, while under a high rate environment, mortgage maturities would lengthen, and floating rate loans subject to caps would be shown as fixed rate assets.

- Gap reports depict the existing structure of the bank at one point in time. Exposures arising from new business generally are not captured.

- Repriceable investments/funds may roll off at rates significantly different from current rates. This can cause a change in earnings even if the bank has a balanced gap position. To aid in the assessment of this reinvestment risk, some banks will show the rates associated with the repricing volumes in their gap reports.

Many assets and liabilities have repricing dates that are unspecified (are not clearly established in the contract or are not otherwise readily determinable). Examples of such instruments include demand deposits, savings accounts, and credit cards. As noted earlier, the repricing dates for products with embedded options will vary depending on future interest rates. To stratify these balances, management must make informed estimates regarding their effective repricing dates. An analysis of a gap report must include a review of management's assumptions on how these balances are stratified.

To address the limitations of gap reports, banks often complement gap reports with simulation models.

Pricing of Assets

Conclusions drawn from the analysis of the bank's interest rate sensitivity position rest upon the assumption that the bank has an adequate asset pricing mechanism. A pricing mechanism that is not attuned to the bank's cost of funds, overhead costs, credit risk, and a reasonable return to shareholders will not allow the bank to maintain an adequate net interest margin on an ongoing basis. Pricing methods and interest rate sensitivity are interdependent factors when an examiner is assessing the bank's ability to maximize and maintain the spread between interest earned and interest paid.

The major component of pricing is the cost of funds. Bankers generally price from either the average cost of funds or their marginal cost. The average cost of funds is a weighted average of all of the rates paid on interest bearing liabilities, which is easily understood, computed, and applied. However, in periods of rising interest rates and/or shifts in the bank's liability structure toward higher cost funding sources, it results in a cost estimate that is too low. The marginal cost of funds is defined as the cost of the additional funds needed to support asset growth. That cost is considered the more appropriate method economically since funds on the balance sheet already support assets held, and their cost should not enter into the pricing decision for new assets.

Funds Management Policy Guidelines

As more banks are attracting funds on a cost competitive basis, the need for properly supervised funds management policies increases. The board of directors has ultimate responsibility for the institutional exposure to interest rate risk and should establish overall strategic policy and adopt constraints on the level of risk assumed. A good policy should generally provide for forward planning that considers the unique characteristics of the bank, management goals regarding asset and liability mix, desired earnings, and margins necessary to achieve desired earnings. Forward planning should also anticipate funding needs and the means available to meet those needs. The policy should establish responsibility for funds management decisions and provide a mechanism for the necessary coordination between the different departments of the bank. This responsibility may be assigned to an asset liability management committee (ALCO).

In addition to establishing responsibility for planning and day-to-day funds management decisions, the policy should set forth certain guidelines. Examples of some typical guidelines are:

Liquidity:

- Balance sheet ratio limits. For example, a limit on total loans/total deposits and purchased funds/total assets.

天 Limits on the sources of funds, such as:

-- Concentrations in funding sources.

-- Use of broker/dealers.

-- Maximum use of a particular wholesale funding market.

天 Limits on uses of funds.

天 A percentage limit on the relationship between anticipated funding needs and available sources. For example, the ratio of primary sources/anticipated needs shall not fall below a certain percent. (Primary sources for meeting funding needs should be defined.)

天 Limits on the minimum/maximum average contract (not repricing dates) maturity for different categories of liabilities. For example, the average maturity of negotiable certificates of deposit shall not be less than a stated number of months.

Rate Sensitivity:

天 Limits on the acceptable level of earnings at risk arising from mismatches between the repricing of assets, liabilities, and off-balance sheet contracts carried on a historic cost basis. These limits are best expressed in terms of net interest income at risk. Limits should also address the risk to earnings arising from positions that are carried on a market valuation basis. This includes trading positions and assets held for resale. Limits on these positions are best expressed in terms of the risk to market values.

天 Limits on earnings exposure should consider potential adverse changes in interest rates rather than anticipated rate movements. The magnitude of an appropriate rate movement will depend on the length of time within which a bank could realistically act to close a position. This reaction time may vary from overnight for liquid trading instruments, to a year or longer for illiquid long-term positions.

天 Banks with significant unmatched, long-term, fixed rate positions should evaluate and limit the severity of this exposure.

Management Information Systems

A workable management information system is central to sound funds management decisions. Reports that contain certain basic information should be prepared and reviewed regularly. Report content and format will vary from bank to bank depending on its characteristics, the funds management practices used, and the risks being measured. For example, a good management information system for assessing liquidity would contain reports that detail liquidity needs and the sources of available funds. The contracted (not repricing) maturity distribution of assets and liabilities and expected funding of commitments would prove useful in preparing this report. In contrast, reports used for interest rate risk management would focus on repricing maturity distributions rather than contractual maturities.

Report content should reflect the complexity of the bank's funds management activities. Examples of items that may be addressed in a report include:

Liquidity:

- Liability customer concentration reports that reflect total funds provided by a particular entity.
- Liability concentrations by:
  - --Market segment (foreign banks, brokers).
  - --Market instrument (interbank funds, Eurodollars).
  - --Geographic distribution.
- Reports that track the amounts and names of wholesale funding customers and changes in the amounts of funds provided by each and the reasons why.

Rate Sensitivity:

- Asset yields, liability costs, net interest margins, and variations both from the prior month and budget. (Reports should be detailed enough to permit an analysis of the cause of interest margin variations.)
- Historical interest margin trends.
- Repricing maturity reports and, if applicable, information on interest rate caps and floors.
- Past consumer behavior patterns on products with unspecified maturities or embedded options.

General:

- Any exceptions to policy guidelines.
- Economic conditions in the bank's trade area, interest rate projections, and any anticipated deviations from original plan/budget. Additional reports may be needed. Funds management decisions should be made on an informed basis through a good management information system.

EXAMINATION OBJECTIVES

1. To evaluate the management of the bank's assets and liabilities.

2. To determine if management is planning adequately for liquidity needs and if the bank can meet anticipated and potential liquidity needs.

3. To determine if reasonable parameters have been established for the bank's rate-sensitivity position and if the bank is operating within established or reasonable parameters.

4. To determine if internal management reports provide the necessary information for informed funds management decisions and for monitoring the results of those decisions.

5. To initiate corrective action when funds management policies, practices, or procedures are deficient.

EXAMINATION PROCEDURES

1. Complete or update the Internal Control Questionnaire, and prepare a brief description of the bank's funds management policies and practices.

2. Review interim financial statements and internal management reports paying particular attention to:

    a. Asset mix and trends.

    b. Liability mix and trends.

    c. The relationship between rate sensitive assets and rate sensitive liabilities and trends.

    d. Stability of interest margins under varying economic conditions. (Causes of significant fluctuations should be identified.)

    e. The volume of liquid assets compared to total assets and volatile liabilities.

    f. Source and use of funds.

3. Review the bank's written funds management policy for reasonableness. At a minimum, it should discuss:

    a. Liquidity parameters.

    b. Source and use of funds.

    c. Acceptable levels of concentrations in funding sources.

    d. Maturities.

    e. Acceptable maturity mismatches.

    f. Whether brokered funds will be employed and, if so, to what extent.

    g. Minimum levels of liquid assets.

    h. Specific limits on acceptable levels of interest rate risk.

    i. Contingency funding plans.

    j. Whether to employ off-balance sheet interest rate contracts (financial futures, interest rate swaps).

    k. Net interest margin goals.

    l. Mechanisms for monitoring interest rate risk.

    m. Responsibilities within the bank for funds management functions.

    n. Reporting mechanisms.

In connection with performing steps 4 through 11, keep in mind the need to evaluate the effectiveness of internal management reporting systems in providing for adequate supervision of funds management.

4. Determine if management has properly planned for liquidity needs and if the bank has adequate sources of funds to meet anticipated or potential needs over the short term by:

    a. Reviewing the internal management report detailing liquidity requirements and sources of liquidity.

    b. Reviewing the minutes of the asset liability management committee or the board of directors for discussions regarding liquidity risk management.

    c. If adequate internal management reports are not available, obtaining the information needed to determine the bank's ability to meet funding needs. This analysis may be prepared for any period considered appropriate, e.g., for a 30-day period or for the next seasonal period if the bank experiences seasonal fluctuations.

    d. Preparing the analysis schedule and evaluating the bank's ability to meet anticipated or potential needs.

    e. Considering the bank's current and projected asset quality and earnings.

    f. Reviewing the most recent liability-related internal management reports to determine the liability customer mix and stability.

    g. Determining the retail and wholesale market acceptance of the bank's name by reviewing any changes in the types of funds providers, pricing versus the market, broker/dealer treatment, and available maturities.

5. Obtain and review for adequacy any existing contingency funding plan. An effective plan should include:

    a. An administrative section outlining the roles of key managers in a liquidity crisis.

    b. Quantification of vulnerable source funds and realistic additional funding sources or salable liquid assets.

    c. A list of probable funding strategies in vulnerable markets, and pricing and policies for early payment of term liabilities.

6. Evaluate the bank's management of its rate sensitivity position by:

    a. Obtaining and reviewing rate sensitivity reports and information used by management to monitor interest rate risk and determining:

        天 If management monitors rate sensitivity through gap analysis:

            天 The timeliness of the report data.

            天 Whether all assets and liabilities and relevant off-balance sheet items are included. If not, ascertain management's reasons for the exclusions.

天 Whether appropriate analysis has been performed to estimate the rate maturities of instruments with noncontractual repricing dates, such as DDA, regular savings, and credit cards. Determine that management has considered seasonal fluctuations, historic volume trends, and current and expected interest rates.

天 Whether reasonable prepayment assumptions were made in stratifying fixed rate mortgages.

b. For any monitoring system used, determine if critical assumptions are identified, periodically reviewed for validity, and documented.

c. If a significant imbalance exists in the bank's rate sensitivity position, determining the effect on future earnings if management's projected interest rate scenario does not materialize.

d. Determining the bank's ability to adjust its rate sensitivity position.

e. Considering the effect of financial futures transactions and other off-balance-sheet activities on the bank's rate sensitivity position.

7. Determine the adequacy of interest margins. If margins are inadequate, or if a declining trend is evident, determine:

天 If goals have been established for net interest earnings.

天 Management's success in meeting established goals.

天 The effect of the bank's rate sensitivity position on meeting established goals.

天 The effect of the bank's pricing policies on meeting established goals.

8. Determine if management is adequately planning for longer term, liquidity/funding needs by:

天 Discussing with management and/or reviewing budget projections for the appropriate planning period. Prepare the Projected Source and Use of Funds Statement.

天 Reviewing the Projected Source and Use of Funds Statement to determine the future direction of the bank and noting the growth projected, source of funding for growth, and any projected changes in asset or liability mix.

天 Evaluating the reasonableness of future plans regarding funds management.

天 Ascertaining whether the bank can achieve the amounts and types of funding projected and can achieve the amounts and types of asset growth projected.

天 Ascertaining whether the degree of risk associated with the bank's projected rate sensitivity position will be within reasonable limits.

9. Evaluate the effectiveness of internal management reporting system in providing for adequate supervision of funds management.

10. Write in appropriate report format, and discuss with management general remarks on:

    a. The current adequacy of liquidity and reasons for the adequacy.

    b. The quality of the bank's planning to meet liquidity needs and the current ability of the bank to meet anticipated and potential liquidity needs.

    c. The bank's rate sensitivity position and an assessment of the degree of risk associated with the bank's position.

    d. The quality of administrative controls and internal management reporting systems.

    e. The effect of funds management decisions on earnings.

INTERNAL CONTROL QUESTIONNAIRE

Discuss with senior management the bank's funds management policies and practices.

1. Has the board of directors, consistent with its duties and responsibilities, adopted a funds management policy which includes:

    - Lines of authority and responsibility for funds management decisions?
    - A formal mechanism to coordinate asset and liability decisions?
    - A method to identify liquidity needs and the means to meet those needs?
    - Requirements for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
    - Guidelines for the level of rate sensitive assets and rate sensitive liabilities and the relationship between them?
    - Limits on the risk to earnings arising from historic cost accounts and instruments carried on a market valuation basis?

2. Does the planning and budgeting function consider liquidity and rate sensitivity?

3. Has provision been made for the preparation of internal management reports, which are an adequate basis for funds management decisions and for monitoring the results of those decisions? And:

    - Are internal management reports concerning liquidity needs and source of funds to meet those needs regularly prepared and reviewed by the board of directors and senior management?
    - Are reports prepared on the bank's rate sensitivity?
    - Is historical information regarding asset yields, cost of funds, and net interest margins readily available?
    - Are variations in the interest margin, both from the prior reporting period and from the budget, regularly monitored?
    - Is sufficient information available to permit an analysis of the cause of interest margin variations?
    - Is corrective action taken when unfavorable interest margin trends are detected?

4. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination procedures)?

5. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____(good, medium, or bad).

INTRODUCTION

The examination of related organizations must be of sufficient scope to determine compliance with law and to evaluate the bank's investments through appraisal of related organizations' assets, earnings, and management. In addition, the examination must fully disclose the nature of the relationship between the bank and its related organizations and its effect on the affairs and soundness of the bank.

Forms of Related Organizations

No matter what the legal organization, a satisfactory relationship between a bank and its related organization(s) is essential to the bank's sound operation. Related organizations may assume several forms. They may be categorized as:

- Affiliates.
- Subsidiaries.
- Foreign subsidiaries.
- Significant subsidiaries.
- Associated companies.
- Other related organizations.

Affiliates

There is no standard definition of the term "affiliate"; however, for examination purposes, "affiliate" is defined to include any corporation, business, association, or other similar organizations:

- Of which the bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the shares voted in the preceding election of directors, trustees, or other persons exercising similar functions, or controls in any manner the election of a majority of the directors, trustees, or other persons exercising similar functions;
- Of which control is held, directly or indirectly, through stock ownership, or in any other manner, by the shareholders of the bank who own or control either a majority of the shares of such bank or more than 50 percent of the shares voted in its preceding election of directors or by trustees for the benefit of the shareholders of any such bank;
- Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one bank; or

- Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a bank or more than 50 percent of the shares voted in the preceding election of directors of a bank, or which controls, in any manner, the election of a majority of the directors of a bank, or for the benefit of whose shareholders or members, trustees hold all, or substantially all, of the capital stock of a bank.

Transactions with affiliates are referred to as "covered transactions." Covered transactions include, but are not limited to: (1) a loan or extension of credit to an affiliate; (2) a purchase of or an investment in securities issued by an affiliate; (3) or a purchase of assets (including assets subject to repurchase) from an affiliate. The volume of covered transactions should be reasonable in relation the bank's capital structure. For any one affiliate, the aggregate amount of covered transactions with a bank and its subsidiaries should not exceed 10 percent of the bank's Tier 1 capital. For all affiliates, the aggregate amount of covered transactions with the bank and its subsidiaries should not exceed 20 percent of the bank's Tier 1 capital.

Any "covered transaction" should be made on terms and conditions that are consistent with safe and sound banking practices. The purchase of low-quality assets from an affiliate should be criticized as an unsafe and unsound banking practice. Low-quality assets are generally defined as substandard, doubtful, loss, other assets especially mentioned, or delinquent.

Banks should only engage in transactions with affiliates on terms and under circumstances (including credit standards) that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or in the absence of comparable transactions, on terms and under circumstances (including credit standards) that in good faith would be offered to or would apply to, nonaffiliated companies.

Operating Subsidiaries

Operating subsidiaries are corporations in which the bank owns at least 80 percent of the voting stock and which may only perform functions the parent bank is legally authorized to perform. Transactions between the parent bank and its operating subsidiary are not subject to limitations. However, book figures for operating subsidiaries must be consolidated line-for-line, after the elimination of inter- company items, with those of its parent to apply applicable statutory limitations and to prepare the report of examination. Each schedule in the report of examination must be prepared to reflect the combined figure of the bank and its operating subsidiaries; and, in analyzing the bank's condition, consolidated figures should be used. If the bank owns less than 100 percent of the voting stock of an operating subsidiary, consolidation will produce a liability account for "minority interest in operating subsidiaries."

Factors which should be considered in making the determination to examine a subsidiary are:

- The percent of ownership and amount of the bank's investment in the subsidiary.

- The nature of subsidiary's business.

- Types and amounts of inter-company transactions.

- Types and amounts of purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations.

- Types of services the subsidiary performs for the bank or other related organizations.

- The bank's outstanding contingent liabilities in favor of the subsidiary.

- The bank's potential contingent liabilities, morally or legally, as a result of lawsuits pending against the subsidiary.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of:

- Asset quality.

- The volatility, maturity, and interest rate sensitivity of the asset and liability structures.

- The bank liability for guarantees issued on behalf of the corporation.

Domestic Subsidiaries

Domestic subsidiaries are any majority owned companies domiciled in Iraq. Such subsidiaries may also be considered operating subsidiaries.

Foreign Subsidiaries

Foreign subsidiaries are any majority-owned companies domiciled in a foreign country. Prudent banking practice and bank safety and soundness considerations requires that bank's maintain effective systems of records, controls, and reports that keep the bank's management informed of the activities and conditions of its subsidiaries.

On-location examinations of these and lesser-owned subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in countries such as Switzerland, Singapore, Luxembourg, and the Bahamas also preclude on-the-spot examinations. In instances where on-location examinations cannot be performed, foreign subsidiary reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Significant Subsidiaries

Significant subsidiaries refers to subsidiaries which meet any one of the following tests:

- It is a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts.

- It is a majority-owned subsidiary for which the bank's share of the gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues.

- It is a majority-owned subsidiary whose "income (loss) before income taxes" amounts to 5 percent or more of the parent bank's "income (loss) before income taxes."

- It is a majority-owned subsidiary that is the parent of one or more subsidiaries which, when consolidated, constitutes a "significant subsidiary" as defined above.

Associated Companies

Associated companies are ones in which the bank directly or indirectly owns 20 to 50 percent of the outstanding common stock, unless the bank can rebut to the CBI the presumption of exercising significant influence. Investments in such companies are

generally appraised like commercial loans by a credit analysis of the underlying financial information.

Other Related Organizations

Other related organizations include companies in which the bank or non-bank affiliate does not necessarily have any direct investment, but which the bank sponsors and/or advises in its activities. In most cases, because of non-ownership or less-than-majority ownership, legal authority to conduct an examination does not exist.

Evaluation of Related Organizations

In order to properly evaluate affiliates and other related organizations relative to the overall condition of the bank, the examiner must:

- Know the applicable laws, rulings, and regulations that define and establish limitations with respect to loans to, investments in, and extensions of, credit to affiliates.

- Make a thorough analysis of the propriety of the related organizations' carrying value, the nature of the relationship between the bank and its related organizations, and the effect of such relationship upon the affairs and soundness of the bank.

Prudent banking practice requires that the bank's "investment in subsidiaries" accounts be adjusted at least quarterly for the bank's proportionate share in the net assets of each subsidiary and associated company. That adjustment will represent a charge or credit to current income to reflect the bank's proportionate share of the net income or net loss of the subsidiary or associated company. In the event a bank has failed to make the appropriate adjustments on its books, the matter should be discussed with management for prompt corrective action and be noted in the report of examination. Adjustment does not apply to investments in foreign subsidiaries whose income is not remittable. Investments in those subsidiaries is to be carried at cost or at fair market value, whichever is lower.

Goodwill results from the cash purchase price of a corporation being in excess of the book value of that corporation. Banks may book goodwill as another asset.

Propriety of the carrying value by a bank's investment in any related organization is determined by evaluating the balance sheet and operating statement of the company in which the bank has the investment. At times, that may not seem important to the overall condition of the bank because the amount invested may not be large relative to the bank's capital funds. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying legal obligation may be substantial and may greatly exceed the total amount of the reported investment.

When examining and evaluating the bank's investment in, and loans to, related

organizations, classified assets held by such companies should first be related to the capital structure of the company and then be utilized as a basis for classifying the bank's investment in, and loans to, that company.

One problem that may be encountered in attempting to make the asset evaluation of some subsidiaries and associated companies is that of inadequate on-premises information. That may be especially true of foreign investments, subsidiaries, and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-upon standards for that information in the future. The examiner must insist that the bank have adequate supporting information available or readily attainable in the bank and that the information be of sufficient quality to allow an informed evaluation of bank's investment. Bank management, as well as regulatory authorities, must be informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, that they have some on-premises control of the company, such as board representation, and that they have audit authority. In the case of an associated company, that implies that the bank should participate in company affairs to the extent practicable.

Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office. That information can best be obtained through full audits by reputable certified public accountants.

For foreign subsidiaries, in addition to audited financial information prepared for management, the bank should have on file:

- Reports prepared for foreign regulatory authorities.
- Information on the country's cultural and legal influences upon banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation.

Intercompany transactions and relationships must be fully disclosed, and their propriety, whether payment for services rendered; payment for facilities used, such as premises, personnel, or equipment; or payment for assets sold, must be determined. Difficult as it may be, the examiner must review and
evaluate the quality and nature of loans, investments and future commitments, and fees paid or received between a bank and its related organizations to determine:

- Adherence to laws, rules, and regulations.
- Effect on the bank's earnings and liquidity.

  --Reasonableness of any costs incurred.

  --The bank's ability to afford such cost.

- Overall soundness of the relationship.

  --The necessity of the service or asset.

  --The level of competence of the service or quality of the asset.

In addition to determining the effects of intercompany transactions, the examiner must also determine if such related organizations are detrimental to the bank because they generate adverse publicity, engage in illegal activities, or cause a conflict of interest for an officer or director.

Within certain limits, the separate corporate existence of non-bank affiliates provides a legal screen between the bank and its affiliates. However, history has demonstrated that difficulties with a holding company or its non-bank subsidiaries can be detrimental to the bank. Thus, the condition and operations of related organizations must be carefully reviewed when determining the condition of the bank. An examination keeping that in mind will help lessen the possibility that problems arising in particular related organizations will lead to unforeseen problems for the bank.

Management and Other Fees

Banks often obtain goods and services from shareholders and insider-related organizations. The arrangement may benefit the bank since the supplier may offer lower costs because of economies of scale such as volume dealing. Furthermore, banks may be able to purchase a package of services which otherwise might not be available. However, because of the interrelationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the bank to shareholders or insider-related organizations should have a direct relationship to and be based solely on the fair value of goods and services provided. Fees should only compensate the supplier for providing goods and services which meet the legitimate needs of the bank.

Banks should retain satisfactory records which substantiate the value of goods and services received, their benefit to the bank, and their cost efficiencies. An examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of three methods:

- Reimbursement for cost of goods or services.

- Cost plus a reasonable profit margin.

- Comparative fair market value.

Any of those methods may be acceptable, as long as the bank can substantiate that the fees paid are reasonable for value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages,
occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt service requirements of shareholders or other related organizations are not legitimate overhead expenses which may be passed on to a bank.

Generally, the CBI considers payment of excessive fees an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination. When prior payment of excessive fees results in additional taxes for the bank, the taxes should be paid by the recipient or the directors responsible for approving the fees.

EXAMINATION OBJECTIVES

1. To determine if policies, procedures, and internal controls regarding related organizations are adequate.

2. To determine if bank and non-bank officers are operating in conformance with the established policies.

3. To determine compliance with applicable laws, rulings, and regulations.

4. To evaluate the bank's investment in and loans to its subsidiaries and the propriety of those carrying values.

5. To determine the relationships between the bank and its related organizations and the effect of those relationships upon the affairs and soundness of the bank.

6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

EXAMINATION PROCEDURES

During the pre-examination analysis of the bank, a determination of which related organizations are to be examined in depth should be made. The criteria for that determination are:

- All operating subsidiaries must be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the CBI Bank Supervision Department.

- Other subsidiaries are examined except when relationships between the subsidiary, its parent, and other related organizations is fully disclosed by material on hand, and the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination to examine a subsidiary are:

  --The bank's percent of ownership and USD amount of investment in the subsidiary.

  --Nature of the subsidiary's business.

  --Types and amounts of intercompany transactions.

  --Types and amounts of purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations.

  --Types of services performed by the subsidiary for the bank or other related organizations.

  --Outstanding contingent liabilities by the bank in favor of the subsidiary.

  --The bank's potential contingent liabilities, moral or legal, as a result of litigation, claims, or assessments pending against the subsidiary.

In many instances, other subsidiaries also meet the definition of some other type of subsidiary, and the examining criteria for such subsidiaries then apply.

Non-bank affiliates are examined in conjunction with the examination of the bank when the CBI deems it necessary to determine the nature and extent of interaction between a bank and its non-bank affiliates. Factors to be considered in making the determination to examine are:

- USD amount of loans or advances by the bank.

- Nature of business of the non-bank affiliates.

- Types and amount of intercompany transactions.
- Types and amounts of assets purchased, sold, or swapped.
- Types of services performed for or by and fees paid or received.
- Outstanding contingent liabilities by the bank in favor of its non-bank affiliates.

Factors which should be considered in making the determination to examine non-banking subsidiaries are:

- When total assets of subsidiary are equal to 10 percent or more of consolidated net worth of the bank.

- Subsidiaries net profits or losses equal 5 percent or more of consolidated gross operating revenue of the bank.

The following procedural steps should be performed in all banks which have related organizations:

1. Complete or update the Related Organizations section of the Internal Control Ouestionnaire.

2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.

3. Obtain the following reports and/or forms which, where appropriate, were prepared or filed since the preceding examination:

    a. Current report.

    b. Quarterly report.

    c. Annual Report to Shareholders.

    d. Required reports to foreign banking authorities for foreign subsidiaries.

    e. Subsidiary and affiliate reports.

4. Request that the bank prepare a complete listing of related organizations.

5. Circulate a list to examiners assigned to each bank department setting forth the names of the related organizations and the loans to and investments in these organizations. The accuracy and completeness of this information should be verified.

6. Obtain information concerning receivables from or payables to related organizations from examiners assigned to "Other Assets and Other Liabilities."

7. Review the bank's files and reports obtained in step 3, and transcribe pertinent financial data and comments regarding related organizations.

8. Review fees paid by the bank to related organizations, bank insider-related organizations, and stockholders, and determine that they represent reasonable reimbursement for goods and services received by:

    a. Determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value).

    b. Reviewing documentation maintained by the bank substantiating the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected.

c. Comparing schedule of fees currently in effect to those in effect 12 months ago.

d. Comparing the fees paid during the last 3 months to those paid for the same period one year ago.

9. Based on the information obtained above, review and comment on the following for each related organization:

   a. The quality of loans, investments, and future commitments to any related organization.

b. The nature and volume of transactions between the related organization and the bank and:

- Extent of any purchase, sale, or swap of assets between the bank and the related organizations and the propriety of the transaction and related consideration.

- Fees such organizations charge the bank for services rendered and the reasonableness of those fees.

- Fees received by the bank from such organization for use of bank personnel, premises, marketing services, and equipment, etc., and the adequacy of those fees.

- Any agreements, guarantees, pledges, or hypothecations between the bank and any related organization, and if they are properly reflected on the books of the bank, and whether there are any exploited conflict of interest situations.

c. Litigation where the related organization is a defendant in a suit, and if the litigation could have an adverse effect on the bank.

d. Each interlocking officer and/or director relationship and:

- Whether fees or salaries are excessive for duties performed.

- If adequate time is devoted to management responsibilities.

10. Determine compliance with laws, rulings, and regulations pertaining to related organizations.

11. Determine, from the results of previous steps and discussion with management, if there are any anticipated changes in related organization/bank relationship which may possibly have adverse effects upon the affairs and soundness of the bank.

12. Based on the above steps, comment on the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship upon the affairs and soundness of the bank.

13. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, consider the necessity of an in-depth examination of related organizations. Perform appropriate procedures in step 14, and develop specific procedures based on type and scope of activities being conducted.

14. The following procedures should be considered where an in-depth examination of non-bank subsidiaries is deemed appropriate (the examiner-in-charge should

confer with the Director of Bank Supervision before undertaking such an examination):

a. Review and evaluate loan and investment quality of the non-bank subsidiaries (use procedural steps from other programs such as "Investment Securities," "Commercial Loans," etc.), and:

- Appraise the quality of the loan portfolio and investments.
- Review activity in and adequacy of valuation reserve.
- Analyze frequency and circumstances of all asset transfers and loan participations.
- Review non-accrual policies for significant distortions and comparability.
- Review and evaluate future commitments, and detail them by subsidiary.
- Detail concentrations of credit to individuals and/or groups or industries, if evident.

For non-bank subsidiaries:

- Review and appraise any funding agreements with the bank.
- Review and appraise any funding agreements with, and debt instruments issued to, outside creditors.
- Review agreements with third parties involving outright purchase of assets to determine liability for repurchase of assets or any other contingent liabilities.
- Review and assess debt structure with attention to matching of debt and asset maturities.

c. Analyze cash flow and earnings of non-bank subsidiaries, prepare cash flow statements for previous 3 fiscal years, and compare current year-to-date with previous year-to-date.

d. Review and evaluate capital adequacy by:

- Relating the consolidated classified assets of the subsidiaries against the consolidated net worth, or relate classifieds proportionately to the banks investment in and advances to each subsidiary.

- Commenting on overall capital structure of specific non-bank subsidiaries, as warranted.

- Discussing adequacy of capital with management and noting management's future plans to raise capital.

e. Review and evaluate management and control policies within the subsidiary by:

- Reviewing board meeting minutes and assessing director interest in and awareness of affiliates.

- Reviewing and evaluating management's internal audit procedures for those policies.

- Reviewing "management letters" from certified public accountants about those internal controls.

- Reviewing shareholder records, noting significant concentrations and, in cases where officers/directors are involved, noting any undue influence with regard to policies, practices, and procedures.

f. Review management's future operating plan for the subsidiary, and:

- Analyze subsidiary's earnings and capital projections for 1 and 5 years.

- Obtain underlying assumptions for:

  --Return on assets.

  --Dividend retention rate.

  --Asset growth rate.

  --Capital growth rate.

- Compare projections against past operating performance, and comment on plan.

15. Discuss findings and conclusions reached in the examination(s) of any non-bank subsidiary with management of those entities. Prepare a separate report of examination where an in-depth examination was performed.

16. Prepare, in appropriate report form, and discuss with appropriate management:

    a. The adequacy of written policies on related organizations.

    b. The manner in which bank officers are operating in conformance with established policy.

    c. Violations of laws, rulings, or regulations.

    d. Impropriety of any transaction between the related organization and the bank.

    e. Loans to and/or investments in related organizations, which for any reason, the examiner questions quality, carrying value, or ultimate collection.

    f. Litigation, commitments, contingent liabilities, and/or current or anticipated changes between the bank and its related organizations which may have adverse effects on the affairs and soundness of the bank.

    g. Interlocking officer and/or director relationships which are detrimental to the bank or any of its related organizations.

    h. Any other information which will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank.

    i. Recommended corrective action when policies, practices, or procedures are deficient.

17. Consolidate information contained in the operating subsidiary report(s) for inclusion in the report of examination.

18. Consolidate financial information and any other comments concerning related organizations for which a separate report was not prepared for inclusion, where appropriate, in the report of examination. A listing of bank affiliates and activities also should be included in the appendix to the report.

19. Prepare a memorandum, and update the work program with any information which will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures concerning related organizations. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

Related Organization Policies and Objectives

1. Does the bank have written guidelines with regard to expansion of services through the formation and/or acquisition of related organizations?

2. To determine that established objectives and policies are adhered to:

    a. Is there an overall lending policy that would bring banking and non-banking related organizations under a common set of controls?

    b. Are bank officials an integral part of subsidiary or related company management?

    c. Can operating procedures be monitored from available internal or external audit reports?

3. Are periodic independent reviews performed to assess bank management objectives and policies with regard to the current status of their association with the related organizations?

4. Does bank management have an active role in the related organizations audit committees, or do they retain the right to examine the companies' records, including the right to receive third party letters from the external auditors?

Related Organization Records

5. Are records maintained for the companies in which the bank has a capital investment including, foreign ones, so that a determination can be made of the extent of bank control, quality of assets, profitability of the company, and legality of operations?

6. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in, and other extensions of credit, security pledged, obligations of any affiliate which is used as collateral security for advances made to others, commitments, and litigation)?

7. Does the bank maintain a copy of all internal and/or external audit reports, including management letters and responses, of the subsidiary or related company?

8. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences upon banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?

9. Is the carrying value of all subsidiaries and related companies adjusted, at least quarterly, to reflect the reporting bank's cumulative share of the company's earnings or losses?

10. Is an objective review performed of the benefits or quality of assets received relative to the cost incurred?

11. Are money transfers between bank and any related organization adequately documented to justify the equity of the transaction?

Conclusion

12. Is the foregoing information considered an adequate basis for evaluating internal controls in that there are no significant additional accounting controls, administrative controls, or other circumstances that mitigate any weaknesses indicated above, and there are no other circumstances that impair any controls (explain negative answers briefly)?

13. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____ (good, medium, or bad).

INTRODUCTION

This section was written to guide the examiner in appraising management and directors' supervision of a bank and evaluating the quality of the decision-making process. These guidelines may be adapted for use in any size or type of bank.

Managing an organization is a continuous process that must address a constant flow of problems and opportunities. In addition to performance, the directors and management should be evaluated in terms of management processes designed to control the organization.

These processes include:

- *Planning*--To ensure that current decisions consider the future operating environment.
- *Policy making*--To develop and communicate a course of action to guide present and future decisions, considering given conditions and assumptions.
- *Personnel administration*--To ensure appropriate recruiting, compensation, training, and personnel development activities.
- *Control systems*--To control and monitor delegated duties.
- *Management information system (MIS)*--To ensure that decision makers receive necessary information at the proper time and place.

The formality of these processes should be based on the organizational structure and diversity of operations. Banks operate differently so an examiner should not expect to find the same scope and documentation of management processes. The relative importance of each should be determined based on both current and future operating environments.

The review should consider the involvement of the directors, shareholders, and officers. Any or all such officials may be involved in management decisions.

Bank directors have a fiduciary duty to shareholders and depositors. They exert this responsibility by ensuring that policies are well defined and management is competent. The board of directors may not delegate responsibility for its duties but may assign the performance of the duties to others.

The nature of a bank's operations should be considered by the directors and management in determining how to supervise and manage a bank. Similarly, the nature of operations should be considered by the examiner in reviewing management and board processes. The examiner should also consider the knowledge, skills, and abilities of individuals to handle current and planned operations and the results of their decisions. When a bank is owned by a holding company, the examiner should determine whether the bank is operated autonomously or follows certain holding company plans or policies. The examiner should also assess management services offered through the holding company or affiliated organizations, such as auditing services or internal loan review.

If the management and board review is performed along with the review of other areas, work should be coordinated to avoid duplication of effort. When possible, information may also be used from previous reviews, examinations, and audits. The guidelines should not be used as a check list for interviewing management, directors, or auditors. Items are listed to assist in organizing the examiner's thoughts. You are encouraged to have discussions with the different levels of management. Such discussions may allow you to gauge awareness and understanding of policies throughout the organization, and indirectly, evaluate the bank's decision-making process.

Remedies

The primary focus of the management and board review is to identify problems before they seriously affect the condition of the bank. Examiner diplomacy is a key in getting management and/or the directors to recognize problems and take appropriate, timely action. The following are suggestions on how to persuade management and directors to address problems when they are reluctant to do so or lack necessary expertise.

The examiner's objective should be to encourage management and/or the directors to take corrective measures without the use of formal action. Examiners should be creative in developing a course of action. A plan that works in one bank may not work in another. Whatever course of action (informal or formal) is taken, the examiner must follow-up until problems are addressed.

Examples of informal actions that may be used include:

- Periodic reporting.
- Board meetings.
- Periodic calls to management and/or directors.
- Periodic meetings with management and/or directors.
- Periodic, brief visits.
- On-site activities.
- Commitment letters.
- Memorandums of understanding.

When problems are serious and well documented, formal administrative action may be warranted. Such actions include:

- Formal agreements.
- Cease-and-desist orders.
- Monetary penalties.
- Removal actions.

The following guidance may be used to identify problems and their causes and to determine the type of information needed to pursue remedial action.

Planning

Planning is an organized and continuous process of ensuring that projections of the future operating environment influence current decisions. Planning can be divided into two classifications: *strategic* (developing a strategy) and *operational*. Strategic planning focuses on the long-term deployment of resources to achieve corporate goals. Operational planning concentrates on short-term actions, which should flow logically from the strategic plan and be revised periodically.

All banks plan; their efforts differ only in thoroughness or degree. The absence of a written plan does not mean management and the board have neglected planning. For banks lacking a written plan, the examiner must obtain the information through interviews. Written plans are desirable, but they do not guarantee that an effective planning process exists. Evaluate the process as well as the product. If a well-designed planning process exists, the plan will generally be thoughtful and realistic.

The examiner should not evaluate bank planning with the preconception that every bank should have a "model" planning process. Discussions with management should address steps in the planning

process that were neglected and potential risks inherent in the plan that were not considered by management.

At a minimum, the board of directors should approve plans and changes to them. Examiners should review board minutes for approvals whenever new activities have been implemented or operations have changed significantly. Depending on the complexity of a bank's operations, the directors' participation in the planning steps may vary. Planning steps may include:

- Developing a mission.
- Evaluating the bank's internal operations.
- Assessing the present and future operating environments.
- Formulating goals and objectives.
- Allocating resources.
- Implementing plans.
- Analyzing results.
- Revising the plan.

Complexity of operations should determine the formality of planning steps in a particular bank. For example, a community bank that is funded primarily by stable, local deposits and that restricts lending to the local area should not be expected to follow the same planning process as a bank that has diverse funding and lending sources.

The degree of planning can also be affected by a bank's organizational structure and process for decision-making. For holding-company subsidiary banks, the level of central control exerted by the parent company will influence the extent of planning autonomy in each bank. The examiner should determine the interaction between the subsidiary bank and the parent company in the planning area and adjust the scope of the review accordingly.

The most important ingredient to an effective planning process is the commitment and involvement of the chief executive officer (CEO). The CEO of any organization is the chief planner. Also, the board of directors should be equally committed. Without support, the planning function will be reduced to an exercise, and plans may be unreliable indicators of future actions.

Policy Making

The purpose of policy making is to provide guidance to employees for making decisions and taking actions. This guidance, known as policies, are statements of direction from management and the board. They indicate a course of action that is expected to achieve a particular goal. Policies should be stated in terms broad enough to allow for varying situations and discretion in execution. At the same time, they should communicate known and agreed upon goals. The anticipated effects of these goals on the organizational structure, financial matters, existing products and services, and marketing should be considered in policy development. Because conditions change, policies should be reviewed periodically to determine whether they have the intended effect or whether revisions are necessary.

The process of developing and implementing policies can provide a number of benefits to the organization:

- An integration of organizational needs, managerial philosophy, and personal preference.
- Consistency of behavior among employees without imposing uniformity.
- Continuity of action even though personnel changes.
- A means to measure results.

Divisional or senior management generally write policies. To do this, they study existing documents, survey industry and community practices, and interview other executives within the organization. Although a bank may obtain written policies from an outside source, management must ensure that they are tailored to the bank. Actions that are acceptable in one institution may be unsafe and unsound in another. The board of directors or a delegated committee should give final approval of policies and subsequent revisions.

The examiner must be alert for situations in which executive management dominates the board or, conversely, where executive management acts solely at the direction of a dominant influence on the board. Such situations generally are detrimental to the bank. Directors must set objectives and formulate policy consistent with their responsibilities. Dialogue between directors and executive management reduces potential conflict in policies.

Personnel Administration

A bank's personnel policies and procedures are vital to the development and continuity of a quality staff. Personnel policies and procedures to consider in determining how well a bank is managed include those relevant to the bank's organizational structure, position descriptions, recruitment program, training and professional development activities, performance appraisal system, compensation, and internal communications.

The structure of an organization should be designed to:

- Guide the efforts of employees (responsibilities, limitations, and reporting requirements).
- Define lines of authority and control.
- Decrease duplication of effort.

An organizational chart is an effective way to communicate some of this information. Position descriptions clarify and amplify information shown by the organizational chart. A comprehensive set of position descriptions forms a factual basis for developing a fair salary structure. They give information about the knowledge, training, and abilities needed for each position. Position descriptions help orient new employees and provide a basis for performance appraisals.

An effective recruitment program enhances the continuity of executive and middle management. Training procedures and advancement policies should be designed to keep the organization viable and dynamic.

Training and professional development activities are available for bank personnel through numerous sources. The quality of a bank's training program is affected by the variety of opportunities provided and the degree of participation by personnel. Only through a review of operating and individual performance can a bank determine whether training is developing its staff adequately.

A formalized appraisal system encourages supervisors to observe employees' performance on an ongoing basis; to emphasize development; and to base decisions on specified standards of performance. The timeliness of appraisals and the degree to which managers follow established procedures also influence the effectiveness of a performance appraisal system.

Performance appraisal procedures must be designed to evaluate the performance of managers. Factors that may be considered for evaluating managers include the ability to carry out policy; to react positively and effectively to adversity; and to recognize and correct problems on a timely basis.

The comparability of a bank's payroll and benefits structure with that offered by competitors affects

the quality of the bank's staff. Salary equity for similar positions within the organization should be considered.

An effective internal communications system improves employee morale and cooperation and discourages duplication of effort. Such a system provides for communication among all levels of the organization. It may include direct dialogue through the lines of authority, and written communication, such as policy and procedures manuals, performance appraisals, management bulletins, and employee handbooks.

Control Systems

To provide sound administration of bank activities, an effective system of controls must be established. Policy making, planning, and personnel administration alone cannot ensure an effectively run organization. As indicated earlier, the board of directors may delegate the performance of its duties to others but may not delegate its responsibility to ensure that a bank is operated in a safe and sound manner. Because of that responsibility, the board and management must implement control systems to monitor the activities of employees associated with the bank.

A bank's control systems may include auditing procedures, internal control procedures, asset quality reviews, risk management, and compliance management. Control systems:

- Help maintain authority
- Recognize and identify management and the board's need for accurate and timely information.
- Verify compliance with policies, plans, and regulations.
- Evaluate risk.
- Inquire into causes of measured deficiencies in performance and monitor follow-up.

Management and directors use various methods for managing and supervising a bank's operations. Any system, regardless of its fundamental soundness, may deteriorate if not reviewed periodically. All control systems must be reviewed continuously to determine whether prescribed policies are interpreted and implemented properly, changes in conditions are addressed, and corrective measures are taken promptly.

Certain control systems should be supervised directly by the board. This ensures that findings and recommendations are not unduly influenced by officers or employees involved in daily operations. Several forms of control systems are discussed briefly in the following comments.

Some type of auditing procedures should be in place in all banks to ensure that management and employees perform their duties in a prudent manner. The audit function should also keep the directors informed on the adequacy of and compliance with policies and controls.

The directors should require periodic reports on management's progress in addressing problems identified in audit reports. Failure to address these problems nullifies the value of the audit function.

Directors must control the selection, evaluation, and compensation of internal and external auditors. Qualifications should be evaluated periodically. The value of the auditors' judgment depends to a large extent on their understanding of the issues being reviewed.

Auditors must have direct access to the board to report their findings. If auditors report to a board committee, the committee should bring key issues to the full board's attention. The directors should review, at least annually, the adequacy of the audit policy, staffing, and coverage.

Internal control procedures are often included as part of a system's normal processing tasks. In general, good internal control exists when no one person can make significant errors or perpetrate irregularities without timely detection. Internal control includes methods to:

- Protect assets.
- Assure the integrity of financial and operating records.
- Promote operating efficiency.
- Promote adherence to policies and regulations.

Asset quality review (including internal loan review) is a bank's method of assessing its major assets. Their value has a far reaching affect on a bank's financial condition. Reviews should include grading problem assets and identifying weaknesses in the lending process. An effective system couples independent review with the identification of loans by officers. Results of asset quality reviews should be reported to the board or an appropriate committee.

Risk management includes the assessment, selection, control, and monitoring of risk. Factors to be addressed may include credit risk, interest rate risk, internal/external fraud risk, exposure to physical hazards, and risks associated with off- balance sheet activities.

Compliance management is a system to promote, monitor, and evaluate adherence to internal policies and applicable laws and regulations. Compliance is a management function deserving the same effort as other management functions. Bank management should make individuals accountable for the bank's compliance program.

Appropriate sections of the "Handbook for Bank Examiners" provide a detailed discussion of internal and external audit, internal controls, and internal loan review.

Management Information System (MIS)

The complexity of banking activities has placed increased emphasis on the quality and extent of information necessary for decision making. Advances in technology have helped banks improve information availability, planning, decision making, and models for analysis.

A comprehensive MIS is usually comprised of special purpose information systems. Reports are generated for a specific purpose and audience. A centralized MIS may be the appropriate system for a small bank but would probably not meet the needs of larger banks. Thus, some information reports may be generated for a small group within a bank and never be seen by senior management. Directors and management need information to define goals, guide operations, and make timely decisions. The management information system should distinguish between the types and uses of information as follows:

- *Corporate planning*--Required by management to achieve long-range plans and objectives, to allocate resources, and to evaluate programs.
- *Managerial control*--Provides management with financial performance and quality control information.
- *Operational control*--Required by line managers to develop and review operating budgets, work schedules, and resource acquisition and utilization plans.

The MIS compiles meaningful information from available sources. The bank's accounting system contributes to any management information system but alone cannot provide management with the information needed to make prudent decisions. The purpose of the accounting system is to process

financial transactions. It may include departmental accounting and measurement of variances from plans. These features are useful in management decision making.

In addition, the management information system should include other nonfinancial information such as personnel statistics. It should include information from external sources on economic conditions, marketplace characteristics, technology, and regulatory requirements.

The effectiveness of management information systems can be measured in terms of quality, quantity, and timeliness. These elements are influenced by analysis of information needs and the system design.

For management and the board to monitor activities and make timely decisions, data must be provided on a continuous basis. This can be accomplished through a well-conceived MIS, designed to meet the needs of the individual bank.

EXAMINATION OBJECTIVES

1. To determine if management has identified the type of organization it wants the bank to be and how it plans to reach its objective.

2. To evaluate the policy-making process.

3. To determine if the bank's personnel activities are monitored by management and the board to ensure consistency with the goals of the organization.

4. To determine if the board and management have implemented adequate control systems.

5. To determine the usefulness of the management information system in evaluating and monitoring bank activities.

EXAMINATION PROCEDURES

In the following procedural steps examiners should attempt to utilize already developed material from internal or external audit sources. Also, the examining resources and circumstances of the bank must be weighted in perspective to set the depth of scope for this area.

1. Obtain the following, if available:

    a. Organization chart
    b. Management plan.
    c. Administrative and personnel manuals
    d. Marketing plan.
    e. Resumes for all executive officers and department or division heads which have not been obtained in previous examinations.
    f. A list of the salary of and other compensation paid to each executive officer.
    g. A list of the salary ranges for other officers of the bank broken down by position.
    h. A description of other employee benefits.

2. Become familiar with the quality of key personnel by:

    a. Updating management briefs for all executive officers and department or division heads.
    b. Distributing the updated management briefs to appropriate examining personnel and requesting that they be returned upon completion.

3. Review administrative manuals and:

    a. Extract any policy statements contained therein.
    b. Extract any general information considered relevant in appraising management.
    c. Analyze the manual(s), in general as useful management tools.

4. Review management plan and extract information concerning:

    a. Areas of bank where increased or decreased officer staffing is planned.
    b. Number of officers to be added or removed.
    c. Qualification requirements for planned additional officers.

5. Establish the hierarchy of the organization by determining the functional responsibility levels of various officers and whether lines of authority are drawn in accordance with the organization chart.

6. Review the bank's marketing plan for specific programs being planned and general applicability to the institution.

7. Review the bank's schedule of salaries and make comparisons with similar information from an appropriate peer group. If deemed appropriate, compare salaries paid and benefits received in the bank to those of other institutions with which it competes directly. Determine whether the bank is paying salaries or bonuses to inactive officers or directors and, if so, determine that such payments have been disclosed to shareholders.

8. Determine whether any executive incentive compensation plans (performance bonuses) have been established and, if so;

a. Review specific provisions of the plans and determine the beneficiaries.
b. Review controls established to prevent the beneficiary(s) of the plan from understating non-cash expenses (accrual expense accounts, provision for possible loan losses, etc.) or overstating non-cash income (accrual income accounts).

9. Review the bank's activities with regard to developing personnel for senior management succession. At a minimum, this review should include:

    a. An assessment of the quality of lower levels of management and the potential for advancement.
    b. An assessment of the bank's officer hiring policies to determine that it is appropriate to meet the bank's current and future needs.

10. Obtain and analyze daily or other periodic reports submitted to executive management with the view of determining the usefulness of the reports in monitoring the condition and operation of the bank.

11. As the evaluation of the various areas of examination interest are being completed, discuss with assisting personnel:

    a. Any of their observations indicative of the general morale level.
    b. The technical proficiency of officers in their area.
    c. The level of direct impact that officers have on the condition of their areas.

12. Review the section on "Income and Expense" and extract any information relating to financial planning that is considered relevant to evaluating management. Also consider the quality, depth and applicability of financial planning.

13. In conjunction with reviewing the workpapers and comments generated during the examination:

    a. Familiarize yourself with the bank's written objectives and policies.
    b. Analyze those policies and determine any inconsistencies in management areas.
    c. Review any internal control and policy exceptions and any other criticisms made in connection with the examination of all areas of the bank.
    d. Determine the extent to which improper implementation is negating the effect of written policies and procedures.
    e. Review the appropriateness of asset distribution in view of the bank's sources of funds.
    f. Review the evaluation of the bank's capital position and expectations in view of asset quality and plans for growth and expansion.

14. In cases where previously obtained information is incomplete or where no records could be reviewed, interview appropriate management in order to judge quality and depth. The interview should be conducted in such a manner as to generate necessary information for determining:

    a. Sources of information used to keep current.
    b. Strengths and weaknesses of lower level personnel.
    c. Succession of management and replacement of key personnel.
    d. General management plan.
    e. Methods of control utilized.
    f. Workload factors and efficiency of personnel.

g. Frequency of staff meetings and how the communications system works.
h. Management projections for the institution over the next year.
i. Any major new proposal being considered or changes in asset mix or services.
j. The nature and degree of working relationship with directors.
k. The existence of any time-consuming outside activities of executive management.

15. By reviewing the results of the preceding steps and performing any other procedures deemed appropriate, answer the following questions (normally these questions will serve as a summary of information obtained, thus compiling factual data to support your objective comments on management):

    a. Have overall management objectives been set?
    b. Does the bank forecast manpower requirements?
    c. Are qualified people advanced from within?
    d. Are supervisory personnel involved in the selection of new employees and given the right of acceptance or rejection?
    e. Is management training given to those persons likely to assume higher level positions?
    f. Are salaries competitive?
    g. Are employee benefit programs competitive?

16. Prepare comments on the quality of management supervision. The comments should, at a minimum, discuss the following:

    a. General and technical ability.
    b. Effectiveness.
    c. Experience.
    d. Any inconsistencies in written objectives, policies and procedures.
    e. Any serious or widespread lack of proper implementation of written procedures.
    f. An evaluation of the bank's salary structure.
    g. The promptness with which management addresses problems.
    h. The extent to which executive management delegates and demands accountability.
    i. Any evidence that executive management is more concerned with the operation of a functional area than with overall supervision of the bank.
    j. The potential for upward movement of existing management personnel.
    k. Management's commitment to effecting corrective action in problem areas.
    l. Unsafe or unsound management.
    m. Any situation which might require close monitoring or removal of management.

17. For banks that are subsidiaries of bank holding companies (BHCs), review the relative degree of centralized control by parent or the lead bank, and evaluate:

    a. The general level of management's dependence on central BHC staff.
    b. Independence on final credit decisions.
    c. Independence on investment decisions.
    d. Independence on operational practices or service fee arrangements.

18. Update the workpapers with any information that will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

1. Does the bank have an organizational chart?

2. If not, have the lines of authority and reporting responsibility been formally established?

3. Does the bank have a full-time personnel manager?

4. Does the bank utilize written personnel manuals?

5. Does the bank utilize a system of written job descriptions, including descriptions for supervisory personnel?

6. Does the bank actively recruit personnel?

7. Does the bank perform background investigations of new employees?

8. Does the bank have a formal training program?

9. Does the bank utilize other training than on-the-job training?

10. Does the bank utilize a graded salary scale?

11. Does the bank consider competition in preparing a salary range? If so, in what manner?

12. Does the top management at least annually review lower management?

13. Does the bank prepare or utilize a long range forecast of economic conditions germane to its trade area?

14. Does top management consult with directors for their opinion of future condition?

15. Does the bank either employ an economist or utilize the services of an outside economic advisor?

16. Does senior management propose to the directors areas for policy decision?

17. Does the bank have a management succession plan?

18. Does the bank employ a marketing manager and/or outside marketing consultant?

19. Does senior management receive:

    a. A brief statement of condition daily?
    b. A daily liquidity report?
    c. A listing of assets subject to quality limitations at least monthly?
    d. An earnings statement on a comparative basis at least monthly?

20. Does the bank's auditing function audit the officer's adherence to general policy?

21. Are staff meetings held on a regular basis?

22. Are minutes kept for staff meetings?

23. Does the bank use a system of progress reports on specific projects?

24. Does the bank have a tax department or a tax consultant?

INTRODUCTION

There are two major types of letters of credit used to finance foreign transactions: the commercial documentary letter of credit and the standby letter of credit. The commercial documentary letter of credit is most commonly used to finance a commercial contract for the shipment of goods from seller to buyer. This versatile instrument may be applied to nearly every type of foreign transaction and provides for the prompt payment of money to the seller when shipment is made as specified under its terms.

Although a standby letter of credit may arise from a commercial transaction, it is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the performance of a purely monetary obligation. The role of the bank in issuing standby letters of credit differs from that used in issuing commercial letters of credit.

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker's payment under a commercial credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, the bank only makes payment on a standby letter of credit when the customer has defaulted on his or her primary obligation will probably be unable to reimburse it.

1. Commercial Documentary Letters of Credit

Numerous factors determine the exact type of commercial letters of credit suitable for a particular transaction:

- The nature of the merchandise.
- The rapport between the exporter and importer.
- The financial standing and reputation of the buyer, the seller, and the opening bank.
- The repetitiveness of the underlying transaction.
- The financing needs of the exporter and importer.
- The availability and cost of financing in different countries.

Commercial documentary letters of credit are issued in irrevocable or revocable form. An irrevocable L/C is a definite commitment by the issuing bank to pay, provided the conditions of the letter have been fulfilled. It cannot be changed unless all parties involved agree. On the contrary a revocable L/C can be cancelled or amended without notice.

An irrevocable letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent located in the same place as the beneficiary. The correspondent bank may act as "advising bank" or "confirming bank". An advising bank does not have any commitment to pay the L/C. A confirming bank substitutes itself to the issuing bank and is committed to pay the L/C provided the beneficiary complies with all the terms and conditions.

Certain categories of commercial credits such as "back-to-back" and "red clause" credits contain additional elements of risk, and banks should exercise caution in negotiating them. Similarly, deferred payment letters of credit, which become direct liabilities of a bank after presentation and receipt of the beneficiary's documents involve greater potential risk when coupled with the length of time the credit is outstanding.

- Back-to-back Letter of Credit:
  A back-to-back letter of credit is issued on the strength of another L/C. Back-to-back L/Cs are appropriate when an intermediary between an manufacturer and a buyer does not have the funds to pay the manufacturer and does not want the manufacturer to know who the buyer is. The intermediary takes the L/C issued by the bank of the buyer to his own bank. The intermediary's bank issues an L/C in favor of the manufacturer, based on the same terms and conditions of the original L/C issued by the bank of the buyer. The L/C issued to the manufacturer does not bear the name of the buyer.

- Red Clause:
  The red clause authorizes the negotiating bank to advance funds prior to the shipment of the goods and the presentation of the documents. It enables the beneficiary to pay its suppliers using another party's funds.

The importance of documentation is paramount in all letter of credit transactions. Many letters of credit are part of continuous transactions evolving from letters of credit to sight drafts or acceptances or to notes and advances secured by trust receipts or warehouse receipts. Ultimate repayment often depends upon the eventual sale of the goods involved. Thus, although the transaction passes through various sections of the international banking division, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

2. Stand by Letters of Credit

Stand by letters of credit are also a common financial instrument. A stand by letter of credit guarantees payment to a beneficiary, by the issuing bank, in the event of default or non-performance by the order party. A stand by L/C related to a commercial transaction is not linked directly to the shipment of goods. If is often used as a guarantee to the performance of a contract (performance bonds, bid bonds, advance payments, loan guarantees…).

EXAMINATION OBJECTIVES

1. To determine if objectives, policies, practices, procedures, and internal controls regarding letters of credit are adequate.

2. To determine whether bank officers are operating in conformance with the established guidelines.

3. To determine the scope and adequacy of the audit function.

4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectability.

5. To determine compliance with applicable laws, regulations, and rulings.

6. To initiate corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or rulings have been noted.

EXAMINATION PROCEDURES

1. Complete or update the Letter of Credit section of the Internal Control Questionnaire.

2. Based on the evaluation of internal controls and the work performed by internal/external auditors (see separate program), ascertain the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal and External Audits," and determine if appropriate corrections have been made.

4. Perform appropriate verification procedures.

5. Obtain a trial balance of the customer liability records, and:

    a. Agree or reconcile balances to department controls and the general ledger.

    b. Review reconciling items for reasonableness.

6. Using the appropriate sampling technique, select customers for examination. If verification procedures have been performed, use the same sample.

7. Prepare examiners' credit line sheets to include details below:

    a. Customer's aggregate letter of credit liability.

    b. Letter(s) of credit aggregating customer's (account party's) total outstanding liability.

        - Undrawn amount.
        - Date of issuance.
        - Expiration date of the credit.
        - Name of the beneficiary.
        - Tenor of the drafts to be drawn.
        - Purpose for the credit.
        - Issued or confirmed.
        - Revocable or irrevocable.

- Negotiable or non-negotiable.
- Revolving.
- Cumulative or non-cumulative.
- Transferable.
- Assignable.
- Amendments.
- Issued on behalf of domestic banks.
- Application (with official approval) is on file and in agreement with letter of credit terms.
- Bank's copy is initiated by the officer who signed the original letter of credit.

8. Obtain from the examiner assigned "Loan Portfolio Management," schedules on the following, if they are applicable to the letter of credit department and may necessitate inclusion of additional customers in the credit review.

    a. Delinquencies.

    b. Participations purchased and sold since the preceding examination (including syndicate participations).

    c. Loan commitments and other contingent liabilities.

    d. Letters of credit issued (or confirmed) for major shareholders, officers, directors, and their related interests.

    e. Letters of credit issued (or confirmed) for employees, officers, and directors of other banks.

    f. Miscellaneous loan debit and credit suspense accounts.

    g. Letters of credit considered problem assets by management.

    h. Information on directors, executive officers, principal shareholders, and their interests.

    i. Specific guidelines in the lending policies.

    j. Each officer's current lending authority.

k. Current letter of credit commission and fee structure.

l. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.

m. Reports furnished to the loan and discount committee or any similar committee.

n. Reports furnished to the board of directors.

o. Loans criticized during the previous examination.

p. A listing of rebooked charged-off loans (arising from letter of credit transactions).

9. Review the information received, and perform the following for:

a. Participations purchased and sold (including syndicate participations).

- Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.

- Determine that the books and records of the bank properly reflect the bank's liability.

- Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.

b. Letters of credit issued (or confirmed) for officers, directors, and their interests:

- Investigate any circumstances which indicate preferential treatment.

c. Letters of credit issued (or confirmed) for officers and directors of other banks.

- Investigate any circumstances which indicate preferential treatment.

d. Miscellaneous loan debit and credit suspense accounts relating to letters of credit.

- Determine liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed by the customer.

- Investigate any large or old items.

e. Loans commitments and other contingent liabilities:

- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

h. Letters of credit criticized during the previous examination:

- Determine disposition of letters of credit so criticized by transcribing:

  -- Current balance and payment status, or

  -- Date the letter of credit was drawn down (refinanced), paid, expired or canceled, and the source of repayment.

i. Rebooked charged-off loans arising from letter of credit transactions:

- Determine that the rebooked loan(s):

  -- Meets the criteria and terms of the bank's lending policy for granting new loans.

  -- Is not subject to classification. If so, list loan for charge-off.

10. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any past-due status relating to letters of credit.

11. Prepare credit line sheets for any letter of credit not in the sample which, based on information derived from the above schedules, requires in-depth review.

12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas, and, together, decide who will review the borrowing relationship. Pass or retain examination credit line sheets.

13. Obtain credit files for all borrowers for whom credit line sheets were prepared, and complete credit line sheets, where appropriate. To analyze the letters of credit, perform the following procedures:

    a. Analyze balance sheet and profit and loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.

    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.

c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.

d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.

e. Review compliance with provisions of letter of credit agreements.

f. Review digest of officers' memoranda, mercantile reports, credit checkings, and correspondence to determine the existence of any problems which might deter the contractual liquidation program.

g. Relate any collateral values, including "margin" and "cash collateral" deposits, to outstanding letter of credit debt.

h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

i. Compare the amount of letters of credit outstanding with the lending officer's authority.

j. Analyze any secondary support afforded by guarantors.

k. Ascertain compliance with the bank's established commercial loan policy.

l. Analyze the following specific types of letters of credit (when applicable) to determine if:

- For Red Clause Letters of Credit (Packing Credits):

  -- Clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) is authorized under the letter of credit.

  -- The beneficiary undertakes to deliver within the expiration date the shipping documents called for in the letter of credit.

  -- The foreign bank makes advances to the beneficiary and is paid by drawing its own draft on the opening bank or the beneficiary is authorized to draw its draft on the issuing bank, and the drafts received charged to the importer.

- For Travelers' Letters of Credit:

  -- The letter of credit authorizes the issuing bank's correspondent to negotiate drafts drawn by the beneficiary

named in the credit up to a specified amount upon proper identification.

-- The customer is furnished with a list of the issuing bank's correspondents abroad.

-- The letter of credit is prepaid in full.

- For Back-to-Back Letters of Credit:

  -- The backing letter of credit is properly assigned as collateral to the bank issuing the letter of credit.

  -- The terms of the letter of credit issued are identical to the backing credit except that:

    - The beneficiary and account party are different.
    - The amount may be less but not more than the backing credit.
    - The expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires.

  -- The beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit.

- For Standby Letters of Credit:

  -- They represent undertakings to pay up to a specific amount upon presentation of a draft(s) and/or documents prior to a specified date.

  -- They represent obligations to a beneficiary on part of the issuer to:

    - Repay money borrowed by or advanced to, or for the account party.
    - Make payment on account of any indebtedness undertaken by the account party.
    - Make payment on account of default by the account party in the performance of an obligation; e.g. default on loans, performance of contracts, or relating to maritime liens.

- For Deferred Payment Letters of Credit (trade related):

  -- The letter of credit calls for drawing of sight drafts, with the proviso that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank.

  -- The bank's liability for outstanding letters of credit calling for deferred payment is reflected as contingent liability until presentation of such documents.

  -- The bank has received, approved, and acknowledged receipt of the documents thereby becoming directly liable to pay the beneficiary at a determinable future date(s).

  -- Payment will be made to the beneficiary in a specified number of months quarterly, semi-annually, annually, etc. (If the bank has advanced money to the beneficiary against the deferred payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a deferred payment letter of credit).

- For Clean Deferred Payment Letters of Credit:

  -- Such deferred payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction.

  -- Such letters of credit are shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank.

- For Authority To Purchase.

  -- The authority to purchase is: with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank.

  -- Drafts drawn on the buyer contain a "Far Eastern Clause."

- For Export-Import Bank:

  -- The bank has an agency agreement from Eximbank stating:

    - Eximbank has entered into a line of credit with a foreign borrower.

    - The amount of the line.

    - The bank has been designated to issue the letter of credit(s). Any payments made under an Eximbank approved letter of credit will be reimbursed by Eximbank.

  -- The bank has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement.

- For Advised (Notified) Letters of Credit:

  -- The bank is only advising the beneficiary without responsibility on its part. (They should not be examined unless the bank has notified the letter of credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)

- For Other Types of Letters of Credit:

14. For loans in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in other loan areas.

15. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.

16. Determine compliance with laws, regulations, and rulings pertaining to letters of credit:

17. Perform appropriate procedural steps in "Concentrations of Credit" section.

18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:

    a. Delinquencies relating to letters of credit.

    b. Letters of credit not supported by current and complete financial information.

    c. Letters of credit on which collateral documentation is deficient.

    d. Inadequately collateralized letters of credit.

    e. Criticized letters of credit.

    f. Concentrations of credit.

    g. Letters of credit issued in favor of major shareholders, employees, officers, directors, and their interests.

    h. Letters of credit which, for any other reason, are questionable in quality and ultimate collection.

    i. Violations of laws, regulations, and rulings.

    j. Other matters regarding the condition of the letter of credit department.

19. Prepare a memorandum to the examiner assigned "Loan Portfolio Management" stating your findings on:

    a. The adequacy of written policies relating to letters of credit.

    b. The manner in which bank officers are operating in conformance with established policy.

    c. Adverse trends within the letter of credit department.

d. The accuracy and completeness of the schedules obtained from "International Loan Portfolio Management."

e. Internal control deficiencies or exceptions.

f. Recommended corrective action when policies, practices, or procedures are deficient.

g. The quality of departmental management.

h. Other matters of significance.

20. Prepare a memorandum, and update work programs with any information which will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with asterisks require substantiation by observation or testing.

Letter of Credit Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:

    a. Establish procedures for reviewing letter of credit applications?

    b. Define qualified customers?

    c. Establish minimum standards for documentation in accordance with applicable laws and regulations?

2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

Letter of Credit Records

3. (*) Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

4. (*) Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?

5. (*) Are delinquencies arising from the non-payment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?

6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements, or post records?

7. (*) Are bookkeeping adjustments checked and approved by an appropriate officer?

8. (*) Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?

9. Are frequent letter of credit record copy and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

Letter of Credit Commissions

10. (*) Is the preparation and posting of commission records performed or reviewed by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

Documentation

12. Are terms, dates, weights, description of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?

13. Are procedures in effect to determine if:

    a. The above documents are signed when required?

    b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?

    c. All amendments to letters of credit are approved by an officer?

Collateral

(See "Commercial Loans" section.)

Deferred Payment Letters of Credit

14. (*) Are deferred payment letters of credit:

    - Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?

- Included in "Other Assets" and "Other Liabilities" in the official CBI reports?

Standby Letters of Credit

15. (*) Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

Other

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?

17. (*) Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?

18. Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with, the domestic bank, recorded as contingent liabilities under the name of that domestic bank?

19. Are any commission rebates approved by an officer?

20. Does the bank have an internal review system that:

    a. Re-examines collateral items for negotiability and proper assignment?

    b. Test checks values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?

    c. Determines that customer payments of letters of credit issued are promptly posted?

    d. Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?

21. Are all letters of credit recorded and assigned consecutive numbers?

22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

Conclusion

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____(good, medium, or bad).

VERIFICATION PROCEDURES

1. Test the addition of the trial balances and the reconciliation of the trial balances to the general ledger.

2. Using an appropriate sampling technique, select letters of credit from the trial balance, and:

   a. Prepare and mail confirmation forms to account parties of letters of credit issued (exclude confirmed letters of credit as they are covered in d. below).

   (Letter of credit participations serviced by other institutions should be confirmed only with the servicing institution. Letter of credit participations serviced for other institutions should be confirmed with the buying (participating) institution and the account party. Confirmation forms should be done in the name of the bank, on its letterhead, and returned to its auditing department with a code designed to direct such confirmations to the examiners. Confirmation forms should include account party, letter of credit number, amount, commission charged, and brief description of collateral, if any.)

   b. After a reasonable time, mail second requests.

   c. Follow-up on any no-replies or exceptions, and resolve differences.

   d. Determine if the bank's confirmation forms agree with incoming tested cable and subsequent written follow-up instructions from the issuing bank.

   e. Examine letters of credit and accompanying documentation for completeness by determining:

      - That they are supported by the required application with officer approval.

      - That all the documents listed in the covering letter have been received, and the letter of credit relates to the draft and documents submitted. Check the letter of credit number of draft.

      - If the letter of credit has expired or been canceled.

      - That the available balance of the letter of credit is sufficient to cover the draft amount.

      - If the exporter is making partial shipments when the letter of credit allows only one shipment to be made for the full amount.

      - If the beneficiary of two letters of credit combines the shipment and presents only one set of documents.

- If the bill of lading is a straight or order instrument.
- That the bill of lading is endorsed to the bank.
- That the bill of lading is not "foul" or "on deck," unless specifically allowed.
- That the commercial invoice does not exceed the amount available under the letter of credit.

- If the weight list detailing each shipping container and its weight certificate stipulating the weight of the merchandise as a whole is signed and agrees with amounts shown on other documents.

- That there is a copy of the packing list for each copy of the merchandise invoice.

- That the insurance policy or certificate is properly endorsed and covers the specific risks enumerated in the letter of credit, that the amounts are correct, and that the description of the goods conforms to that on the letter of credit.

- That the inspection certificate attesting to the quality, quantity, and condition of the merchandise is the same on all other documents.

- That the information on the certificate of origin agrees with the requirements of the letter credit.

- That any required consular invoices are present.

f. Check to see that the required authorized signature of an approving officer is on each letter of credit form whether issued or confirmed.

g. Check to see that the letter of credit issued appears to be genuine.

h. Determine that proper assignments, hypothecation agreements, etc., are on file.

i. Test the pricing of any negotiable collateral.

j. Determine that collateral margins are reasonable and in line with bank policy and legal requirements.

k. List all collateral and documentation discrepancies, and investigate.

l. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.

m. Forward a confirmation request on any collateral held outside the bank. (Confirmation forms sent should be done in the name of the bank, on its letterhead, and returned to its auditing department with a code designed to direct such confirmations to the examiners.)

n. Determine that each file contains documentation supporting counter-guarantees or letters of credit, where appropriate.

o. Review letter of credit participation agreements, making excerpts where necessary for such items as rate of service fee, interest rate, remittance requirements, and determine compliance.

p. Review customer ledgers to determine compliance with line authorizations and letter of credit agreement terms.

3. Review the commission accounts relating to issuing, amending, confirming, and negotiating letters of credit by:

   a. Reviewing and testing procedures for accounting for commissions and the handling of adjustment.

   b. Scanning commissions for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

INTRODUCTION

A bank may guarantee or endorse notes or other obligations sold by the bank for its own account or provide other guarantees for clients as permitted by applicable laws and regulations. The amount of the obligations covered by such guarantee, or endorsement, must be recorded as a liability on the records of the bank. Furthermore, such liabilities are included in computing the aggregate indebtedness of the bank.

All types of guarantees issued should be recorded as contingent liabilities on the books of the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank, or even in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in a separate section.

Examples of Guarantees:

> Loan Guarantees: A bank can issue a guarantee either to another bank or to a private lender to guarantee a loan to an individual or o company. This document will guarantee the repayment of the loan to the lender, should the beneficiary of the credit defaults on its commitment.
>
> Guarantees of repayment: It is often used when an account party is paid part of the value of a contract in advance, to ensure the repayment of the advance if the obligations of the contract are not fully completed.
>
> Shipside bond: Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In such instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, which holds the shipping company blameless of damage resulting from release of the goods without proper or complete documents.
>
> Bid Bonds: This kind of guarantee is used to ensure that a company, which bids for a contract is sincere and able to enter into the contract when awarded.
>
> Performance bonds: A performance bond is a type of guarantee, which can be drawn upon if the order party does not comply with the terms of a contract or fail to perform its commitments. It usually follows a bid bond.

The above guarantees are only few examples and are not an exhaustive list.

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EXAMINATION OBJECTIVES

1. To determine if policies, practices, procedures, and internal controls regarding guarantees issued are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To evaluate the portfolio for credit quality, collectability, and collateral sufficiency.

4. To determine the scope and adequacy of the audit function.

5. To determine compliance with applicable laws, regulations, and rulings.

6. To initiate corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, and rulings have been noted.

EXAMINATION PROCEDURES

1. Complete or update the Guarantees issued section of the Internal Control Questionnaire.

2. Based upon the evaluation of internal controls and the work performed by internal/external auditors (see separate program), ascertain the scope of the examination.

3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal and External Audits," and determine if appropriate corrections have been made.

4. Perform appropriate verification procedures.

5. Obtain a trial balance of the customer (account party) liability records, and:

    a. Agree or reconcile balance to department controls and the general ledger.

    b. Review reconciling items for reasonableness.

6. Using the appropriate sampling technique, select guarantee account parties for examination. If verification procedures have been performed, use the same sample. (Before proceeding, refer to step 16. This step should be performed in conjunction with steps 7 through 15.)

7. Prepare credit line sheets to include:

    a. Customer's aggregate guarantee issued liability.

    b. Guarantees issued aggregating customer's total outstanding liability.

8. Obtain from the examiner assigned "Loan Portfolio Management" schedules on the following, if they are applicable to the guarantees issued area:

    a. Loan commitments and contingent liabilities.

    b. Miscellaneous loan debit and credit suspense accounts.

    c. Loans considered "problem loans" by management.

    d. Specific guidelines in the lending policy.

    e. Each officer's current lending authority.

f. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.

g. Reports furnished to the loan and discount committee or any similar committee.

h. Reports furnished to the board of directors.

i. Loans criticized during the previous examination.

j. A listing of rebooked charged-off loans (arising from guarantee issued transactions).

9. Review the information received, and perform the following for:

    a. Miscellaneous loan debit and credit suspense accounts:

        - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.

        - Discuss with management any large or old items.

        - Perform additional procedures as deemed appropriate.

    b. Loan commitments and other contingent liabilities:

        - Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

    c. Rebooked charged-off loans arising from guarantee issued transactions:

        - Determine that the rebooked loan(s):

            -- Meets the criteria and terms of the bank's lending policy for granting new loans.

            -- Is not subject to classification. If so, list loan for charge-off.

10. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any past due status.

11. Prepare credit line sheets for any guarantee not in the sample which, based on information derived from the above schedules, requires in-depth review.

12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks--time, and other loan areas, and, together, decide who will review the borrowing relationship. Pass on or retain completed credit line sheets.

13. Obtain credit files for all customers (account parties) for whom credit line sheets were prepared, and complete credit line sheets, where appropriate. To analyze the guarantees, perform the following procedures:

    a. Analyze balance sheet and profit and loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.

b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.

c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.

d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate the adequacy of those sources.

e. Ascertain compliance with provisions of guarantee agreements.

f. Review digest of officers' memoranda, mercantile reports, credit checkings, and correspondence to determine the existence of any problems which might deter the contractual liquidation program.

g. Relate collateral values, if any, to outstanding guarantee.

h. Compare fees charged to the bank's fee schedule, and determine that the terms are within established guidelines.

i. Compare the original amount of the guarantee with the lending officer's authority.

j. Analyze support afforded by counter-guarantors.

k. Ascertain compliance with the bank's established guarantee issued policy.

14. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.

15. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate account parties contained in the sample. Cross-reference line sheets to borrowers, where appropriate.

16. Determine compliance with laws, regulations, and rulings pertaining to guarantees issued.

17. Perform appropriate procedural steps in "Concentrations of Credit."

18. Discuss with appropriate officer(s), and prepare summaries in appropriate report form of:

    a. Delinquencies relating to guarantees issued.

    b. Guarantees not supported by current and complete financial information.

c. Guarantees on which collateral documentation is deficient.

d. Concentrations of credit.

e. Criticized guarantees.

f. Inadequately collateralized guarantees, if applicable.

g. Guarantees issued in favor of major shareholders, employees, officers, directors, and related interests.

h. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.

i. Violations of laws, regulations, and rulings.

j. Other matters regarding the condition of the guarantees issued department.

19. Prepare a memorandum to the examiner assigned "International Loan Portfolio Management" stating your findings on:

    a. The adequacy of written policies relating to guarantees issued.

    b. The manner in which bank officers are operating in conformance with established policy.

    c. Adverse trends within the guarantees issued department.

    d. The accuracy and completeness of the schedules obtained from "Loan Portfolio Management."

    e. Internal control deficiencies or exceptions.

    f. Recommended corrective action when policies, practices, or procedures are deficient.

    g. The quality of departmental management.

    h. Other matters of significance.

20. Prepare a memorandum, and update work programs with any information that will facilitate future examinations.

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures for issuing and servicing guarantees. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with asterisks require substantiation by observation or testing.

Guarantees Issued Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:

    a. Establish procedures for reviewing guarantee applications?

    b. Define qualified guarantee account parties?

    c. Establish minimum standards for documentation in accordance with applicable laws and regulations?

2. Are guarantees issued policies reviewed at least annually to determine if they are compatible with changing market conditions?

Guarantees Issued Records

3. (*) Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

4. (*) Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items and adequately investigated by persons who do not normally handle guarantees?

5. (*) Are guarantee delinquencies prepared for and reviewed by management on a timely basis?

6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?

7. Are bookkeeping adjustments checked and approved by an appropriate officer?

8. (*) Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees canceled or renewed, payment made under guarantees, and fees collected, which supports general ledger entries?

9. Are frequent guarantee instrument and liability ledger trial balances prepared, and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

Guarantee Fees

10. (*) Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

11. Are independent fee computations made, compared, or adequately tested to initial fee records by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

Collateral

(See "Commercial Loans" section.)

Other

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?

13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?

14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

Conclusion

15. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____(good, medium, or bad).

VERIFICATION PROCEDURES

1. Test the addition of trial balances and their reconciliation to the general ledger.

2. Using an appropriate sampling technique, select guarantees issued from the trial balance, and:

    a. Prepare and mail confirmation forms to account parties. (All confirmation forms should be done in the name of the bank, on its letterhead, and returned to its auditing department with a code designed to direct such confirmations to the examiners. Guarantees serviced by other institutions, either whole guarantees or syndicate participations, should be confirmed only with the servicing institution (or lead bank.) Guarantees serviced for other institutions, either whole guarantees or syndicate participations, should be confirmed with the buying institution and the account party. Confirmation forms should include account party's name, guarantee number, amount, fee charged, and a brief description of any collateral or counter- guarantee held.)

    b. After a reasonable time, mail second requests.

    c. Follow-up on any no-replies or exceptions, and resolve differences.

    d. Examine guarantees issued instruments for completeness, and agree date, amount, and terms to the trial balance.

    e. In the event any guarantees issued are not held at the bank, request confirmation by the holder.

    f. Check to see that required initials of the approving officer are on the guarantee instrument.

    g. Check to see that the signature on the guarantee is authorized.

    h. Compare any collateral held with the description on the collateral register.

    i. Determine that the proper assignments, hypothecation agreements, etc., are on file.

    j. Test the pricing of any negotiable collateral held.

    k. Determine that collateral margins are reasonable and in line with bank policy and legal requirements.

    l. List all collateral discrepancies, and investigate.

    m. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.

n. Forward a confirmation request on any collateral held outside the bank.

o. Determine that each file contains documentation supporting counter-guarantees, if applicable.

p. Review guarantee participation agreements, making excerpts, where necessary, for such items as fees charged the account party or remittance requirements, and determine whether the account party has complied.

q. If the bank has to pay a beneficiary under its guarantee, review disbursement ledgers and authorizations to determine whether payment was effected in accordance with the terms of the guarantee agreement.

3. Review fees collected accounts by:

a. Reviewing and testing procedures for accounting for fees collected and for handling any adjustments.

b. Scanning fees collected for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.

Workpaper Documentation

Background

The documentation of examiner findings is an integral element to successful onsite bank supervision. Such documentation should be written and organized in a manner that allows not only the responsible bank examiner to formulate accurate conclusions but also allows third-party reviewers to understand how and why particular conclusions were reached.

It is the purpose of this discussion paper to establish the standards whereby appropriate workpapers are prepared during bank examinations. It is the responsibility of each participating examiner to prepare workpapers supporting the work completed during the examination process.

Workpaper Preparation

The term "workpapers" represents all significant items used by a bank examiner to complete their bank examination assignment. These items include many possibilities and may range from internally prepared bank reports to management reports prepared by the Central Bank of Iraq (CBI). Specifically, such bank items may include, but are not limited to:

- Balance sheet and income statement
- Loan trial balance (original or copy)
- Bank Reporting Forms
- Relevant information from prior bank examination
- Offsite analysis reports
- Internal audit reports
- External audit reports
- Bank prepared analyses (liquidity, investments, borrowings, large deposits)
- Examiner prepared analyses (capital, assets, earnings, liquidity, sensitivity)
- Examiner prepared minutes from meetings with bank personnel
- CBI internal reporting/analytical documents
- Examiner prepared conclusion memorandums
- Examiner prepared report of exam comments

From these types of information, the examiner completes the examination analysis, using the required procedures dictated by the onsite examination manual. During the onsite investigation, the examiner gathers and reviews written documents that support the conclusions being made. Throughout the examination process, it is necessary for the examiner to retain either original or copies of the significant documents used in order to appropriately document the conclusions noted.

Workpaper Format and Organization

The examiner shall prepare workpaper documents in an organized, consistent format. These workpapers serve as the archive (historical) support for all examination conclusions relating to the particular examination. Therefore, they must be organized in a consistent manner. Such documents should be organized at the end of the examination process in a logical manner and eventually be stored for future reference.

Each examination component must be organized according to the subject area. For example, an examination workpaper format may include the following (with reference numbers):

- Examination Planning & Control WP 101
- Internal/External Audit WP 102
- Capital WP 303
- Loan Portfolio Management WP 205
- Management WP 502
- Earnings WP 401
- Deposit Accounts WP 301
- Funds Management/Liquidity WP 405
- Foreign Exchange/Dealing Room WP 806
- Examination Conclusions WP 503

Individual file folders must be prepared for each section of the examination. These folders will hold all the relevant information, i.e, such as that listed above. The Work Paper numbers noted above correspond to the organizational number assigned that subject within the onsite manual. The file folder cover should contain the relevant data and may be formatted as follows:

Section 303

Examination Date: XX/XX/XX Prepared by:
Financial Information as of: XX/XX/XX Reviewed by:

Capital

1. Examination Conclusions
2. Report of Examination Comment
3. Capital Analysis Worksheet
4. Capital Analysis from prior bank examination
5. Most recent offsite analysis report - Capital
6. Bank reporting form – capital – dated XX/XX/XX
7. Banks Capital Position as of XX/XX/XX
8. Bank Balance Sheet dated XX/XX/XX
9. Bank Income Statement dated XX/XX/XX
10. Minutes from meeting with bank management held on XX/XX/XX

Based on this basis of this cover page, the actual working papers are organized in the folder in a logical, indexed manner. Once the workpapers are organized, the front-page index can be prepared. Individual working papers should be indexed internally tying to the general categories established on the workpaper folder cover.

Once workpapers are finalized, they must be reviewed by the examiner-in-charge (EIC). Upon this review, the EIC will determine whether or not the workpapers adequately support the conclusions reached. If there are inadequacies, the examiner must revise/enhance such workpapers in order to obtain the final EIC signature approval on the cover of the workpapers documents. It is the responsibility of the EIC to ensure the workpapers are adequate to support the conclusions of the particular examination program as well as the overall examination itself.

Workpapers will be used to support the examination conclusions. Thus, all the programs performed during the examination must be organized in a manner that allows future use and reliance on such work. Each of the component programs performed during the examination must be organized in a manner that they are stored in a secure location in a logical manner. A possible solution would be to store the individual files together in a

storage box clearly marked with all examination specific references. This box would then be stored in secure cabinet or closet.

Conclusions

Examination workpapers are a core component to the examination process. Whenever bank examiners perform regulatory reviews, the work completed must be well documented and stored for possible future use. Having such historical support will ensure a well planned, consistent approach to onsite bank supervision.

Section Heading

Bank
Examination Date

Prepared by: _____
Approved by: _____

Examination Procedures	Document Ref. Number	Comments
1.		
2.		
3.		
4.		

Examination Procedures	Document Ref. Number	Comments
5.		
6.		

Name of Bank: _____
Examination Date: _____
Prepared by: _____
Reviewed by: _____
Date of Review: _____

INTERNAL CONTROL QUESTIONNAIRE

Review the bank's internal controls, policies, practices, and procedures concerning <title of the section>. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

Title of the Section	Internal Written Policy	Actual Process
1.		
2.	Yes ☐ No ☐	Yes ☐ No ☐
3.	Yes ☐ No ☐	Yes ☐ No ☐
4.	Yes ☐ No ☐	Yes ☐ No ☐
5.	Yes ☐ No ☐	Yes ☐ No ☐
6.	Yes ☐ No ☐	Yes ☐ No ☐
7.	Yes ☐ No ☐	Yes ☐ No ☐
8.	Yes ☐ No ☐	Yes ☐ No ☐
9.	Yes ☐ No ☐	Yes ☐ No ☐
10.	Yes ☐ No ☐	Yes ☐ No ☐
11.	Yes ☐ No ☐	Yes ☐ No ☐
12.	Yes ☐ No ☐	Yes ☐ No ☐
13.	Yes ☐ No ☐	Yes ☐ No ☐
14.	Yes ☐ No ☐	Yes ☐ No ☐
15.	Yes ☐ No ☐	Yes ☐ No ☐
16.	Yes ☐ No ☐	Yes ☐ No ☐
17.	Yes ☐ No ☐	Yes ☐ No ☐

Conclusion		
18. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.		
1.	Yes ☐ No ☐	Yes ☐ No ☐
2.	Yes ☐ No ☐	Yes ☐ No ☐
19. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered	Totally adequate ☐ Generally adequate ☐ Partially adequate ☐ Inadequate ☐	Totally adequate ☐ Generally adequate ☐ Partially adequate ☐ Inadequate ☐

Introduction

Certain report pages are mandatory for all full-scope bank examination reports prepared by Central Bank of Iraq examiners. These pages address the examiner's conclusions and provide information on capital, asset quality, management, earnings, and liquidity (CAMEL).

Central Bank of Iraq Report Instructions

The following instructions provide general guidance to the examiner in evaluating certain aspects of a bank's operations and in completing the report; they are not intended to constitute a technical manual on conducting examinations and completing reports, nor are they designed to set forth all of the factors, considerations, and issues that examiners must address and evaluate when they conduct examinations. In addition, these instructions are not intended to address legal and compliance questions; rather, examiners should consult appropriate laws, regulations, and examiner guidelines.

Instructions for specific pages follow in the order recommended for their inclusion in full scope examination reports.

The following terms are used on many report pages containing financial information. Guidance requirements and options available for each term is provided here.

> Examination Date (or Exam Date). The date of the financial data used for the examination activity or the ending date of the period reviewed. If the date of the asset-quality review is different from the exam date, any required use of "exam date" in connection with asset quality should refer to the date of the asset-quality review.
>
> Period Ended. No specific timeframe is designated. These columns reflect information for a time period deemed most appropriate by the examiner to support conclusions presented in the Report of Examination. For comparative purposes, this column may reflect financial data from the same period of the prior year as the examination date, the prior quarter, or the most recent year-end.

The examiner-in-charge is responsible for selecting dates deemed most appropriate to present the examination findings. If a bank's management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiners' numbers should be shown in the report and used to calculate any ratios used in the report. Columns titled "Period Ended" should usually detail previous year-end information. However, the examiner may substitute different dates, such as those of the previous examination, when desired. Care should be taken in computing all ratios to ensure that ratios are accurate and consistent throughout the report.

CBI Examination Report Page List

The following table lists the Central Bank's report pages in the order in which they would usually appear, along with a notation of whether their inclusion in the report is mandatory or optional.

Mandatory/ Optional	Report Page Title
	OPEN SECTION
Mandatory	Table of Contents
Mandatory	Scope
Mandatory	Matters Requiring Board Attention
Mandatory	Examination Conclusions and Comments
Optional[1]	Compliance with Enforcement Actions
Mandatory	Violations of Laws and Regulations
Mandatory	Capital Adequacy
Mandatory	Asset Quality
Mandatory	Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases
Mandatory	Management/Administration
Mandatory	Analysis of Earnings
Mandatory	Sensitivity to Market Risk
Mandatory	Liquidity/Asset Liability Management
Optional	Concentrations
Optional	Other Matters
	Appendix
Mandatory	Comparative Statements of Financial Condition
Mandatory	Comparative Statement of Earnings
Mandatory	Capital Calculations Optional
Mandatory	Summary of Items Subject to Adverse Classification
Optional	Summary of Items Listed as Special Mention
Optional	Assets with Credit-Data or Collateral-Documentation Exceptions
Mandatory	Signature of Directors
	CONFIDENTIAL SECTION
Mandatory	Directors
Mandatory	Executive Officers
Mandatory	Management and Control
Mandatory	Ratings and General Information

Some optional pages are mandatory if the circumstances exist. For example, "Enforcement Actions" is mandatory if the bank is subject to mentioned.

These pages may be augmented with supplemental information as needed or required by the Central Bank of Iraq. Additional supporting schedules and visual aids (for example, graphs and charts) may also be

included in the report to communicate and support the examiner's findings.

Central Bank of Iraq

REPORT OF EXAMINATION

_____
(Complete name of the Bank)

License No.____

_____
(Legal address of the Bank)

Examiner in Charge_____

Examination date _____*(as of Financial Information)*_____

This report contains the results of an examination of _____ conducted by the Central Bank of Iraq. It is a confidential document and remains the property of the Central Bank of Iraq. The board members, directors, managers, or employees of the bank may not disclose the contents under any circumstances. In the event a legal procedure requires disclosure of the report, the bank shall immediately advise the Central Bank of Iraq about the latter.

The said examination is not an audit and does not replace it.

Table of Contents

Page

Scope……

Matters Requiring Board Attention…….

Examination Conclusions and Comments……...

Compliance with Enforcement Actions……..

Violations of Law and Regulations…….

Capital Adequacy…….

Asset Quality……

Management/Administration……

Earnings……

Liquidity/Asset Liability Management…….

Concentrations…….

Other Matters……

Appendix

Comparative Statements of Financial Condition…….

Comparative Statement of Earnings……

Capital Calculations…….

Summary of Items Subject to Adverse Classification…….

Summary of Items Listed as Special Mention…….

Signature of Directors……..

Scope of Examination

The Scope page is used to list areas reviewed during the examination and describes the extent of those reviews. The examiner should generally address the following:

- The date of examination (commencement and conclusion)
- The type of examination (full-scope, targeted)
- Areas reviewed and analyzed (If the examination is targeted, the examiner should identify specific areas reviewed.)
- The percentage and type of loans reviewed.
- A confirmation that examination results were discussed with the organization and a list of those attending the meeting.
- If necessary, recognition that the bank is operating under a formal or informal supervisory action. (If so, state that the provisions of the action were reviewed and compliance was assessed.)

Matters Requiring Board Attention

The Matters Requiring Board Attention page is used to inform the bank's board of directors of the most significant issues identified during the examination. It should summarize the most important examination/inspection findings and is intended to complement the complete Report of Examination findings prepared for use by bank management and directors. This page is to focus on identified problems, rather than on strengths of the organization, and present them succinctly and unmistakably clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted. Institutions rated 4 or 5 are to be told they are problem institutions that warrant special supervisory attention. Institutions rated 3 are to be informed that their condition is not satisfactory, that they are subject to more-than-normal supervision, and that they may become problems if their weaknesses are not addressed adequately.

This page should also discuss significant weaknesses in 1- or 2-rated institutions. In institutions where no specific matters are identified as requiring board attention, this page should provide a brief summary of the institution's condition. In all cases, this page should contain a concluding statement reminding the directorate of its responsibility to review the entire Report of Examination and instructing each director to sign the Signature of Directors page.

Examination Conclusions and Comments

CAMEL Ratings

	Current Examination	Prior Examination	Prior Examination
Exam Date:			
Composite Rating:			
Component Ratings:			
Capital			
Asset Quality			
Management			
Earnings			
Liquidity			
Examiner-in-Charge			
Additional Sign-off			

The report page should list the composite rating for the current examination and for the two previous examinations at the top of the page. This listing should be followed by the uniform definition of the assigned composite rating. Definitions are as follows:

Banks with a composite rating of "1" are sound in all aspects, generally have components rated 1 or 2 and are in substantial compliance with laws and regulations. Any weaknesses can be handled routinely by the board of directors and management. Banks are considered stable, well managed and capable of withstanding all but the most severe economic downturns. Risk management practices are strong and minimal supervisory oversight is required to ensure the continuation and validation of the bank's fundamental soundness.

Banks with a composite rating of 2 are fundamentally sound, generally no component is rated higher than "3", and are in substantial compliance with laws and regulations. Only moderate weaknesses are present and well within the capabilities of the board of directors' and management's capability and willingness to correct. These banks are stable and can withstand most economic downturns. Overall risk management practices are satisfactory and there are not material supervisory concerns.

Banks rated "3" generally have weaknesses in one or more component areas that if not corrected within a reasonable time frame could result in significant solvency or liquidity concerns. Management may lack the ability or willingness to effectively

address weaknesses in a timely manner and these banks generally are less capable of withstanding business fluctuation and are vulnerable to outside influences. Risk management practices may be less than satisfactory and banks in this group may be in significant noncompliance with laws and regulations. Failure appears unlikely, however, given the overall strength and financial capacity of these banks.

Banks rated "4" indicate serious unsafe and unsound practices and serious financial or managerial deficiencies that result in unsatisfactory performance. The weaknesses and problems are not being satisfactorily resolved by the board of directors and management. Risk management practices are generally unacceptable and there may be significant violations with laws and regulations. Problems range from severe to critically deficient and require close supervision and specific remedial action. The overall solvency of the bank is threatened if immediate and specific supervisory action is not taken.

Banks rated "5" exhibit extremely unsafe and unsound practices or conditions, critically deficient performance and their risk management practices are inadequate. The volume and severity of problems are beyond management's ability or willingness to control or correct. Failure is highly probable and immediate outside financial or other assistance is needed and on-going supervision is necessary.

This report page should summarize examination findings, particularly those of significance and also provide an overview of the bank's financial condition. The examiner's major recommendations and management's plans for corrective actions should be covered in appropriate detail, with references to additional supporting information elsewhere in the report. Comments should also elaborate on the matters requiring board attention listed on the preceding page. All comments should be presented in order of importance. The comments should be primarily on an exception basis, describing areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerability. This does not preclude the examiner from recognizing positive actions taken by management; however, laudatory or conclusive remarks and endorsements of specific management actions should be avoided. Significant violations should be discussed briefly and in greater detail on the Violations of Laws and Regulations page; less serious violations should be noted and reference made to the violations page. Compliance with any enforcement actions should also be briefly discussed and state that details are provided on the Compliance with Enforcement Actions page. The Examination Conclusions and Comments page and the Matters Requiring Board Attention page should not be duplicative.

Compliance with Enforcement Actions

The Compliance with Enforcement Actions page will be used if the bank is under any type of supervisory action or has ratified board resolutions at the request of the Central Bank of Iraq. In all cases, the type and date of the action or resolutions should be noted. In addition, the examiner should generally list each provision requiring action and provide a comment addressing compliance with that provision. Specifically, the examiner should comment on how the bank accomplished compliance or the reason why the bank is not in compliance with a particular provision. These comments should be made at the examination when supervisory actions are initiated and at all subsequent examinations until the action is removed.

Violations of Laws and Regulations

The Violations of Laws and Regulations page should be included in every Central Bank of Iraq examination; if there are no apparent violations, write "None." When violations of laws and regulations are found, they should be listed in detail on this page.

The format for listing violations should be consistent. A heading for each violation listed should name the applicable regulation and section and provide a brief description of what the law covers. This should be followed by a brief description of the requirements of the regulation or statute and a discussion of how or why the violation occurred. The examiner should describe any plans or recommendations for correction.

Capital Adequacy

Capital adequacy is evaluated in relation to supervisory guidelines, the nature and extent of risks to the organization, and the ability of management to address these risks. Consideration is given to the level and quality of capital and the overall financial condition of the bank; the nature, trend, and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposures presented by off-balance sheet activities; the quality and strength of earnings; balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans and prospects; the reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and the ability of management to address emerging needs for additional capital.

Component Rating X

Ratio	Exam Date	Period Ended	Period Ended
Total risk-based capital/risk-weighted assets			
Tier 1 risk-based capital/risk-weighted assets			
Tier 1 leverage capital/average total assets			

Capital is assessed at each full-scope examination. Consideration is specifically given to risk identified within the bank, equity maintenance, and any growth the bank might be experiencing.

The bank's capital ratios should be presented as indicated on the report page. In cases when the condition of the bank has changed significantly since the last quarter-end (for example, an equity offering) and/or when examination findings have a material impact on conclusions regarding capital adequacy, the examiner should reflect these changes and findings in these ratios.

The examiner should consider the volume of classified assets and any meaningful asset-quality trends. It is appropriate to address capital ratios adjusted for significant examination classifications in the narrative to emphasize the impact of examination classifications on any valuation reserves and the impact of deficiencies in valuation

reserves on the bank's capital adequacy.

The assessment of capital growth should include consideration of growth from various capital sources, including retained earnings and potential new capital-stock issues, and should be compared to growth in total assets, asset mix, market risk, concentration risk, risks associated with nontraditional activities, interest-rate risk, and off-balance-sheet risks. Risk-based capital guidelines factor in changes in balance-sheet composition and exposure to potential risk via growth of off-balance-sheet activities. Although the guidelines give consideration to the above, examiners still must exercise considerable judgment to evaluate all factors necessary to make an accurate assessment of capital adequacy.

The bank's capital plan should also be reviewed. The content, degree of formality, sophistication, and form of plan will vary with banks of different sizes and complexity. However, each bank should be monitoring its capital position in relation to the required guideline ratios and risk. In addition, consideration should be given to the bank's ability to obtain additional outside capital, including support provided by a parent holding company. Also, the bank's dividend history and plans should be considered in relationship to regulatory guidelines and anticipated profitability.

Asset Quality

Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on and off-balance sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; the demonstrated ability to identify, administer, and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; credit risk arising from or reduced by off-balance sheet transactions; asset concentrations; the volume and nature of documentation exceptions; and the effectiveness of credit administration procedures, underwriting standards, risk-identification practices, controls, and management information systems.

Component Rating X

Asset-Quality Ratios and Trends

Ratio	Exam Date	Prior Exam Date	Prior Exam Date
Total adversely classified assets/capital + allowance			
Total adversely classified assets/total assets			
Past-due and nonaccrual loans and leases/gross loans and leases			
Weighted adversely classified assets/capital + allowance			

Central Bank of Iraq examiners should specifically address the following areas on the Asset Quality page. If all conditions are satisfactory, a brief statement that addresses each factor and summarizes the examiner's conclusions will suffice.

- Assess (1) the quality of assets, including their level, distribution, severity, and the trend of problem, classified, past-due, nonaccrual, restructured, and renegotiated loans not in compliance with modified terms for both on- and off-balance-sheet transactions; (2) the existence of asset concentrations; (3) the adequacy of loan policies and loan-administration, credit documentation, or lending practices; (4) the adequacy of workout procedures for problem credits;

(5) the adequacy of the allowance for loan and lease losses; and (6) the adequacy of the bank's internal loan-review and grading systems, including significant differences between internal loan grades and examination classifications.

- Assess (1) the quality of investment securities and (2) the adequacy of investment policies.

- Comment on any off-balance-sheet items, such as unfunded commitments, commercial and standby letters of credit, and lines of credit, with respect to (1) their volume in relation to total assets, capital, or other appropriate balance-sheet categories; (2) the risks inherent in the activity; and (3) the adequacy of management and control of off-balance-sheet risks.

- Comment on the quality of management with respect to the lending function and management's awareness of problem loans. Examiners should also address the causes of existing credit problems and remedial actions agreed to by management for correction of deficiencies.

- Assess the adequacy of internal controls and, management information systems.

Assets listed for special mention should not be included in the classifications total, nor should they be referred to as adversely classified in the narrative. Although classified and special-mentioned asset totals should not be commingled, those two categories will display and possibly share underwriting, documentation, or other weaknesses or characteristics to be reported by the examiner.

The examiner should consider the total of other transfer risk problems, if significant, and briefly discuss the volume and trend of such credits. The examiner should specifically assess whether there are concentrations of credit in any particular economic sectors, the extent that problem credits may be centered in these sectors, and concentrations of transfer risk warranting special comment. Examiners should also address the loan-loss reserve methodology and the adequacy of the allowance for loan and lease losses. Examiners should comment on the quality of investment securities and trading-account activities and address credit risk associated with off-balance-sheet items.

Examiners should assess the adequacy of policies and procedures relating to loans, investments, and off-balance-sheet activities. Also, examiners should address policies and procedures regarding financial futures and foreign-exchange trading.

When assessing loan policies, loan administration, and lending practice, consideration should be given to internal loan approval, internal review and monitoring, and grading systems and control procedures; the organization and completeness of the credit files; collateral administration and evaluation procedures; collection procedures; procedures for renewing or extending loans and placing loans on nonaccrual status; the accrual and

capitalization of past-due interest and prepaid interest; and any other unfavorable practice that may result in or from poor asset quality.

Deficiencies relating to the lack of written policies in any critical area should be noted in discussing management's adherence to policies on the Management/Administration page. Also, if excessive management turnover, weaknesses in middle management, or inadequate internal promulgation of policies affects adherence to or implementation of policies, these areas should also be addressed under Management/Administration.

Management/Administration

Management and the board of directors are evaluated against all factors necessary to operate the institution in a safe and sound manner and their ability to identify, measure, monitor, and control the risks of the institution's activities. Consideration is given to the level and quality of oversight and support provided by management and the board; compliance with regulations and statutes; the ability to plan for and respond to risks that may arise from changing business conditions or initiation of new products or services; the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems; the responsiveness to recommendations from auditors and supervisory authorities; the reasonableness of compensation policies and avoidance of self-dealing; a demonstrated understanding and willingness to serve the legitimate banking needs of the community; management depth and succession; the extent that management is affected by or susceptible to dominant influence or concentration of authority; and the overall performance of the institution and its risk profile.

Component Rating X

Management is evaluated against all factors necessary to operate the institution in a safe and sound manner and in accordance with acceptable practices. In preparation for making report comments, examiners should consider the following:

- the adequacy of supervision by the board of directors, including its role in establishing policies and its responsiveness to recommendations from auditors and supervisory authorities;
- compliance with supervisory agreements;
- compliance with banking laws and regulations;
- management's timeliness in recognizing and resolving problems;
- the adequacy of the institution's policies necessary to operate the bank in a safe and sound manner and in compliance with applicable statutes and regulations (Examiners should review the mechanism for formulating, approving, reviewing, and updating policies; determine if the policies are in writing and are properly communicated to all appropriate personnel; and determine if all policies are followed.);
- management's adherence to policies as established by the board of directors;
- management information systems and controls used to monitor and control risks through-out the bank and ensure compliance with established policies, statutes,

and regulations (Examiners should also address the adequacy of the overall internal accounting-control system and the audit function employed by the bank. Deficiencies in internal accounting-control systems and the audit function should be discussed in detail.);

- the adequacy and effectiveness of the planning function, including planning and budgeting and the role of management in each process;
- the business strategy and policies and procedures for avoiding conflicts of interest;
- management depth and succession;
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority demonstrated willingness to serve the legitimate banking needs of the community;

While topics in this section may appear to overlap with other areas of the report, the discussion in this section should focus on the role of the bank's directors, the bank's internal administration, management supervision and policy development, and management's adherence to operating policies and procedures. This section should not repeat financial assessments set forth elsewhere in the report.

Earnings

Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings: level, trend, and stability of earnings; quality and sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market-risk exposures; adequacy of provisions to the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems.

Component Rating X

Earnings page should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page. On this page, the examiner should address, at a minimum, the following:

- the level of earnings, including trends and stability;
- the quality of earnings (for example, strength of the net interest margin, the amount of non-interest income and expense, reliance on unusual or nonrecurring gains or losses, and adequacy of provisions for loan losses);
- plans for correcting any earnings deficiencies;
- the bank's budget and expense controls, such as management's earnings projections with regard to reasonableness of assumptions, actual results versus projections, and reasons for significant differences between projected and actual earnings;
- the vulnerability of the bank's earnings to interest-rate and other risks (However, full discussion should be in the Liquidity/Asset Liability Management section of the report);
- the ability to provide for adequate capital through retained earnings.

When assessing the quality of net income, the examiner should also consider the amount of interest accrued but not collected and other areas for possible overstatement of income. This amount may be reflected in other assets as income earned or not collected, or in the loan account as capitalized interest (interest added to the loan balance). The examiner should also consider the composition, reasonableness, and extent of management's control over operating expenses.

Liquidity/Asset Liability Management

Liquidity and asset/liability management is evaluated in relation to the trend and stability of deposits; degree and reliance on short-term, volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; availability of assets readily convertible to cash without undue loss; availability to securitize and sell certain pools of assets; access to money markets and other sources of funding; adequacy of liquidity sources and ability to meet liquidity needs; effectiveness of liquidity policies and practices, concentration of authority; and the overall performance of the institution and its risk profile.

Component Rating X

The Liquidity/Asset Liability Management page addresses both overall bank liquidity and balance-sheet interest-rate sensitivity. Liquidity refers to the ability to meet maturing obligations and commitments and incorporates considerations such as availability of funding and the degree of reliance on volatile or concentrated funding sources. Interest sensitivity considers the overall matching of rate sensitivities of assets and liabilities and the responsiveness of asset yields, interest expense, and interest margins to changes in market interest rates.

The examiner should consider the level and/or percentages of core and/or volatile deposits, including the composition and stability of deposits. In particular, the level of volatile deposits should be closely scrutinized, and the examiner should consider if the bank must pay premium rates to attract those funds. Report comments should also consider deposit and other liability concentrations and the extent of the bank's reliance on those concentrations. The examiner should also consider vulnerability of the institution's funding to adverse publicity and lowered credit ratings.

The report should consider the level and types of liquid assets. These assets include cash and due from banks, Iraq government securities and securities purchased under agreements to resell. Liquid assets should be maintained at a sufficient level to cover maturing obligations and allow extended commitments to be fulfilled. The level of temporary investments (securities purchased under agreement to resell, interest-bearing bank balances, trading-account assets, and debt securities with remaining maturities or earliest pricing opportunities of one year or less) should also be considered. The examiner should also keep in mind the percentage of the bank's securities that are pledged against liabilities and be mindful of whether they are available for sale, as well as any market appreciation or depreciation in the investment portfolio.

To further analyze liquidity, a history of the bank's borrowings since the previous examination should be considered. Consideration should be given to the bank's ability

to obtain borrowings from outside sources, should that be consistent with the bank's funding strategy.

The examiner needs to consider the bank's interest-rate risk exposure. The examiner should assess how the bank is monitoring exposure, any weaknesses inherent in the bank's system, and management's plans to correct any inappropriately mismatched positions.

Examiners should assess the adequacy and reasonableness of the bank's policies regarding liquidity, interest-rate risk, and funding, as well as management's compliance with those policies. The examiner should also consider augmenting the discussion of the organization's liquidity and asset/liability management with gap information or other meaningful financial data presented in supporting schedules.

Sensitivity to Market Risk

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; the ability of management to identify, measure, monitor, and control exposures to market risk given the bank's size, complexity, and risk profile; the nature and complexity of interest rate risk arising from non-trading positions; and, where appropriate, the nature and complexity of interest rate risk arising from trading and foreign operations.

Component Rating X

This section reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can affect a bank's earnings or economic capital. When evaluating, the examiner should consider management's ability to identify, measure, monitor, and control market risk; the bank's size and the nature and complexity of its activities; and the adequacy of the bank's capital and earnings in relation to its level of market-risk exposure.

For many banks, the primary source of market risk arises from non-trading positions and their sensitivity to changes in interest rates. In some larger banks, foreign operations can be a significant source of market risk. For some banks, trading activities are a major source of market risk. To analyze a bank's market risk, an assessment of the following evaluation factors should be made:

- the sensitivity of the bank's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices

- the ability of management to identify, measure, monitor, and control exposure to market risk given the bank's size, complexity, and risk profile

- the nature and complexity of interest-rate risk exposure arising from non-trading positions

- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

Concentrations

The Concentrations page is to be used only when concentrations are noted. A brief paragraph at the beginning of the page should be included to inform the reader that the listing is generally for informational purposes and does not necessarily represent criticism unless otherwise specifically stated. This paragraph should also mention that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank's capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance for loan and lease losses.

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank, as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and others are detailed where appropriate. The listing also includes amounts due from depository institutions, and other assets where payment is dependent on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure. Iraqi government securities, obligations of various government agencies and state owned corporations, and any assets collateralized by these items are not included in the listing.

Other Matters

Examiners should use the Other Matters report page to discuss other significant issues that have not been mentioned elsewhere in the report or significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. Examiners should use this report page to make comments on the following specific areas if issues or concerns are noted:

- accounting, audit, and internal controls;
- affiliate relationships;
- criminal referral procedures;
- emergency preparedness;
- financial record-keeping and reporting regulations;
- insurance;
- investment in bank premises;
- litigation;
- security and controls against external crimes;
- payments system risk;
- non-traditional banking activities (for example, mortgage warehousing or data processing services);
- supervisory reporting;

Other examination matters may also warrant comments on this report page.

Appendix

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

(Amounts reported in thousands)

	Examination Date	Period Ended
Assets		
Total Loans and leases		
Less: Allowance for Loan and Lease Losses		
Loans and Leases (net)		
Interest-bearing balances		
Securities purchased under agreements to resell		
Trading Account Assets		
Securities		
Total Earning Assets		
Cash and non-interest bearing balances		
Premises and Fixed Assets		
Other real estate owned		
Intangibles		
Other Assets.		
Total Assets		
Liabilities		
Deposits		
Securities sold under agreements to repurchase		
Other borrowed money		
Other liabilities		
Subordinated Notes and Debentures		
Total Liabilities		
Equity Capital		
Perpetual preferred stock		
Common equity capital		
Other Equity capital		
Total Equity Capital		
Total Liabilities and Equity Capital		
Off-Balance Sheet Items		
Unused loan commitments		
Letters of Credit		
Other Off-balance Sheet Items.		

Comparative Statement of Income

	Examination Date	Period Ended
Income Statement		
Interest Income		
Interest Expense		
Net Interest Income		
Non-interest income		
Total non-interest expense		
Provision for Loan and Lease Losses		
Securities gains (losses)		
Net Operating Income (pre-tax)		
Applicable Income Taxes		
Net Operating Income (after tax)		
Extraordinary credits (charges) net		
Net Income		
Other increases/decreases		
Cash Dividends		
Net change in equity Accounts		
Ratios		
Net Interest income/average earning assets		
Total non-interest expense/average assets		
Net income/average total equity		
Net losses/average total loans and leases		
Earnings coverage of net losses X		
ALLL/Total loans and Leases		
Nonperforming/ALLL		

Reconcilement of Allowance for Loan and Lease Losses

	Examination Date	Period Ended
Beginning Balance		
Gross Loan and Lease Losses		
Recoveries		
Provision for Loan and Lease Losses		
Other increases (decreases)		
Ending Balance		

Capital Calculations

	$(000's)	Date
Tier 1 Capital		
Common stock		
Surplus		
Undivided profits and capital reserves		
Foreign-currency-translation adjustments		
Minority interests		
Subtotal: tier 1 capital elements		
Less:		
Ineligible intangibles		
Other adjustments		
Tier 1 capital		
Tier 2 Capital		
Allowance for loan and lease losses		
Mandatory convertible debt		
Cumulative perpetual preferred stock		
Subordinated debt		
Other		
Tier 2 capital (not to exceed 100% of tier 1 capital)		
Total Tier 2 Capital		
Tier 1 plus tier 2 capital		
Less: deductions		
Total capital		

The Capital Calculations page should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page. When the condition of the bank has changed significantly since the exam date (for example, an equity offering) or when examination findings materially affect conclusions regarding capital adequacy, the examiner should reflect these changes and findings in the capital calculation. When adjustments are made, the examiner should identify the date of the new capital calculation. Characteristics of any capital elements that are unusual or significant may require an explanation on the Capital Adequacy pages.

Summary of Items Subject to Adverse Classification

Adverse Classification

Please, include assets and off-balance sheet items that belong to the following categories:

Substandard Assets: A "Substandard" asset is inadequately protected by the current sound worth and paying capacity of the obligor, or of the collateral pledged – if any. "Substandard" assets must have a clearly defined weakness or weaknesses that jeopardize orderly liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets: Assets classified "Doubtful" has all the weaknesses inherent in one classified "Substandard" with the added characteristic that its weaknesses make collection or liquidation in full (on the basis of currently existing facts, conditions and values) highly questionable and improbable.

Loss Assets: This classification does not mean that the asset has no recovery or salvage value whatsoever. Rather, an asset classified as a "Loss" is considered uncollectible and/or of such little value that continued recognition as a bankable asset is not warranted under current market conditions.

Thousands IRD

Assets category	**Substandard**	**Doubtful**	**Loss**	**Total**
Loan portfolio				
Securities				
Accounts receivable				
Other assets (off balance sheet, etc.)				
Total as of exam date				
Total as of previous exam date				

	Category		
Amount, description, comments	Substandard	Doubtful	Loss

The Items Subject to Adverse Classification page is to be included in the report if any items

are subject to adverse classification. The page should include all assets that are classified but should not include assets listed for special mention. This page should be used by examiners for the individual write-ups for assets subject to classification, including any off-balance-sheet items. It should also be used to list assets subject to classification that do not require write-ups. Assets specially mentioned should be included on the page titled Items Listed for Special Mention.

Summary of Items Special Mention

A **Special-Mention Asset** has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

|

	Exam date	**Previous exam date**
Total "Special Mention" assets		

Description, comments	**Amount**

The Items Listed for Special Mention page is to be used if any items are listed for special mention. Specially mentioned assets must be written up if they exceed the loan review cutoff amount and if the bank's management disagrees with the examiner's findings with regard to the asset. Specially mentioned assets are not to be referred to as "criticized assets."

Loan Distribution

Category	**Amount**	**Percent**
Real Estate Loans		
Installment Loans		
Commercial Loans		
Other Loans and Leases		
Total Gross Loans and Leases		

PAST-DUE LOANS AND LEASES

Category	30-89 Days	90 or More days	Total	Total Past Due/Outstanding
Real Estate Loans				
Installment Loans				
Commercial and other Loans				

Non-Accrual Loans

Category	Past due & Accruing Interest	Past Due & On Non-accrual	Total Past Due	Non-Accrual/Total Past Due
Real Estate Loans				
Installment				

Loans				
Commercial and other Loans				

ASSETS WITH CREDIT-DATA OR COLLATERAL-DOCUMENTATION EXCEPTIONS

Includes assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the Deficiency column.

1 -- Appraisal	5 -- Insurance
2 -- Title Search or Legal Opinion	6 -- Collateral Assignment
3 -- Borrowing Authorization	7 --
4 -- Recordation	8 --

Name or Description	**Amount**	**Date of Most Recent Financial Statement**	**Deficiency Number(s) or Description**
Total			
Percentage of Total Loans			

Instructions

The Assets with Credit-Data or Collateral-Documentation Exceptions page should be included in the report if a significant volume of documentation exceptions is noted. If credit-data or collateral-documentation exceptions are significant, this page should support a discussion of credit-documentation practices on the Asset Quality page. In addition to the six common documentation exceptions listed, the page heading provides space to list other exceptions noted at a particular examination.

SIGNATURE OF DIRECTORS

We, the undersigned directors of _____ , have personally reviewed the contents of the report of examination dated _____ .

Signature of Directors	Date
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONFIDENTIAL SECTION

CONFIDENTIAL SECTION -DIRECTORS

Name[1]	Year of Birth	Year Elected to Board	Occupation or Principal Business Affiliation
_____	_____	_____	_____

Instructions

List all bank directors in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading. Information requested in the report-page header should be supplied for each director. Specific instructions for certain requested information is as follows:

- Under meetings missed, include all meetings a director has not attended between the previous and current examination. If a director was elected since the previous examination, only list the number of meetings that he or she missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, commercial real estate development).
- For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director.

[1] *Number of meetings missed of a total of _____ held since the previous examination. Regular schedule of directors' meetings:*

Fee paid each director:

CONFIDENTIAL SECTION - EXECUTIVE OFFICERS

Name and Title	Area of Responsi-bility	Year of Birth	Years in Present Position	Salary (S) Bonus (B)
_____	_____	_____	_____	_____

Instructions

Include all significant officers. The information requested by the page should be supplied by the bank.

Additional individuals to be reported may include persons without official designation that exercise considerable influence. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first. Specific instructions for this requested information is as follows --

- Examples of areas of responsibility include administration, policy formulation, lending, operations, or branch manager.

- Salary should indicate the current annual salary, and bonus should show total bonuses for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefit programs, or affiliated bank salaries and fees), these should be discussed in a narrative format below the listing of executive officers or on a separate page.

CONFIDENTIAL SECTION-MANAGEMENT AND CONTROL

1. Discuss any other relevant matters regarding the bank's management not previously addressed.

   Instructions: Generally, the examiner's assessment of management should be fully discussed in the open section of the report; however, this question provides a forum to discuss any supervisory matter regarding management that clearly requires confidential treatment.

2. If the bank is in a weakened or extended condition, what aid may be expected from shareholders or others?

   Instructions: Each principal shareholder's ability and willingness to offer support to a weakened bank should be assessed. Any other potential forms of support, such as a parent company, other affiliate, or third party desiring to acquire this bank should also be identified. The possibility or likelihood of forthcoming support should also be addressed.

3. List each major shareholder (5 percent or more) of the bank and the respective percentage of ownership. When the major shareholder is a bank holding company, list its major shareholders and the percent controlled.

   Shareholders **Percentage Owned**

   Instructions: Each major shareholder of the bank should be listed, with footnotes for any indirect control, such as control over spousal or family trust shares. Finally, any special control arrangements, such as buy-sell agreements or control-group structures, should be noted.

4. Comment on the extent to which a particular director(s), shareholder(s), or executive officer(s) controls or dominates the bank's policies and operations.

   Instructions: The degree of control or influence exercised by any one individual or group of individuals should be discussed and include an indication of whether this influence has been positive or detrimental to the bank.

5. Comment on any adverse effects of insiders on operating policies, procedures, or overall financial condition of the bank.

Instructions: In addition to any abusive practices that should be discussed here, such as self-dealing, any other problems, such as incompetent management or other relevant factors, should be addressed.

6. Provide the aggregate amount of borrowings by directors, executive officers, principal shareholders, and their related interests. Describe any material loans or other transactions between the bank and its executive officers, directors, or its direct or indirect principal shareholder(s) and their interest(s), and assess the impact of the transactions on the bank. (An interest would include any holding company affiliate or outside business interest or a bank or holding company insider in which 25 percent or more is controlled.)

   Instructions: The volume of insider borrowings and the impact of those transactions on the bank should be commented on.

7. Has any director, officer, or employee allegedly embezzled, abstracted, or otherwise criminally misused the funds of the bank since the previous examination? If so, have proper authorities been notified? If proper authorities have not been notified, explain why.

   Instructions: Any filing of a criminal referral form relating to insiders should be commented on. The report question also requires the examiner to explain why legal authorities have not been informed of possible criminal activity.

CONFIDENTIAL SECTION -RATING AND GENERAL INFORMATION

1. State the bank's rating at this examination and the date of the rating at the last examination. Briefly discuss the rationale for the rating and reasons for any departures from Central Bank of Iraq implementing guidelines with respect to the CAMEL component ratings and the composite rating.

2. Discuss future prospects of the bank.

   Instructions: Items for possible discussion include the bank's trade area, major employers or primary industries, the area's economic condition and trend, and the bank's ability to operate satisfactorily within this environment. Other discussion topics could include competition, expansion plans, and strategic direction.

3. Was a meeting held with the full board of directors to discuss matters subject to criticism? If not, give names of directors and officers with whom the bank's condition was discussed.

4. Indicate the number of examiner days to complete the pre-examination, on-site, and post-examination work.

Name	On Premises	Off Premises

Central Bank of Iraq

REPORT OF EXAMINATION

_____
(Complete name of the Bank)

License No.____

_____
(Legal address of the Bank)

Examiner in
Charge_____

Examination date _____(*as of Financial Information)*_____

This report contains the results of an examination of _____ conducted by the Central Bank of Iraq. It is a confidential document and remains the property of the Central Bank of Iraq. The board members, directors, managers, or employees of the bank may not disclose the contents under any circumstances. In the event a legal procedure requires disclosure of the report, the bank shall immediately advise the Central Bank of Iraq about the latter.

The said examination is not an audit and does not replace it.

Central Bank of Iraq
Bank Supervision Department

Central Bank of Iraq
Bank Supervision Department

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Scope of Examination

Matters Requiring Board Attention

Examination Conclusions and Comments

CAMEL Ratings

	Current Examination	Prior Examination	Prior Examination
Exam Date:			
Composite Rating:			
Component Ratings:			
Capital			
Asset Quality			
Management			
Earnings			
Liquidity			
Examiner-in-Charge			
Additional Sign-off			

Compliance with Enforcement Actions

The Compliance with Enforcement Actions page will be used if the bank is under any type of supervisory action or has ratified board resolutions at the request of the Central Bank of Iraq. In all cases, the type and date of the action or resolutions should be noted. In addition, the examiner should generally list each provision requiring action and provide a comment addressing compliance with that provision. Specifically, the examiner should comment on how the bank accomplished compliance or the reason why the bank is not in compliance with a particular provision. These comments should be made at the examination when supervisory actions are initiated and at all subsequent examinations until the action is removed.

Violations of Laws and Regulations

Capital Adequacy

Capital adequacy is evaluated in relation to supervisory guidelines, the nature and extent of risks to the organization, and the ability of management to address these risks. Consideration is given to the level and quality of capital and the overall financial condition of the bank; the nature, trend, and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposes presented by off-balance sheet activities; the quality and strength of earnings; balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans and prospects; the reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and the ability of management to address emerging needs for additional capital.

Component Rating X

Ratio	Exam Date	Period Ended	Period Ended
Total risk-based capital/risk-weighted assets			
Tier 1 risk-based capital/risk-weighted assets			
Tier 1 leverage capital/average total assets			

Asset Quality

Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on and off-balance sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; the demonstrated ability to identify, administer, and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; credit risk arising from or reduced by off-balance sheet transactions; asset concentrations; the volume and nature of documentation exceptions; and the effectiveness of credit administration procedures, underwriting standards, risk-identification practices, controls, and management information systems.

Component Rating X

Asset-Quality Ratios and Trends

Ratio	**Exam Date**	**Prior Exam Date**	**Prior Exam Date**
Total adversely classified assets/capital + allowance			
Total adversely classified assets/total assets			
Past-due and nonaccrual loans and leases/gross loans and leases			
Weighted adversely classified assets/capital + allowance			

Management/Administration

Management and the board of directors are evaluated against all factors necessary to operate the institution in a safe and sound manner and their ability to identify, measure, monitor, and control the risks of the institution's activities. Consideration is given to the level and quality of oversight and support provided by management and the board; compliance with regulations and statutes; the ability to plan for and respond to risks that may arise from changing business conditions or initiation of new products or services; the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems; the responsiveness to recommendations from auditors and supervisory authorities; the reasonableness of compensation policies and avoidance of self-dealing; a demonstrated understanding and willingness to serve the legitimate banking needs of the community; management depth and succession; the extent that management is affected by or susceptible to dominant influence or concentration of authority; and the overall performance of the institution and its risk profile.

Component Rating X

Earnings

Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings: level, trend, and stability of earnings; quality and sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market-risk exposures; adequacy of provisions to the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems.

Component Rating X

Liquidity/Asset Liability Management

Liquidity and asset/liability management is evaluated in relation to the trend and stability of deposits; degree and reliance on short-term, volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; availability of assets readily convertible to cash without undue loss; availability to securitize and sell certain pools of assets; access to money markets and other sources of funding; adequacy of liquidity sources and ability to meet liquidity needs; effectiveness of liquidity policies and practices, concentration of authority; and the overall performance of the institution and its risk profile.

Component Rating X

Sensitivity to Market Risk

Sensitivity to market risk reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; the ability of management to identify, measure, monitor, and control exposures to market risk given the bank's size, complexity, and risk profile; the nature and complexity of interest rate risk arising from nontrading positions; and, where appropriate, the nature and complexity of interest rate risk arising from trading and foreign operations.

Component Rating X

Concentrations

Other Matters

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

(Amounts reported in thousands)

	Examination Date	Period Ended
Assets		
Total Loans and leases		
Less: Allowance for Loan and Lease Losses		
Loans and Leases (net)		
Interest-bearing balances		
Securities purchased under agreements to resell		
Trading Account Assets		
Securities		
Total Earning Assets		
Cash and non-interest bearing balances		
Premises and Fixed Assets		
Other real estate owned		
Intangibles		
Other Assets.		
Total Assets		
Liabilities		
Deposits		
Securities sold under agreements to repurchase		
Other borrowed money		
Other liabilities		
Subordinated Notes and Debentures		
Total Liabilities		
Equity Capital		
Perpetual preferred stock		
Common equity capital		
Other Equity capital		
Total Equity Capital		
Total Liabilities and Equity Capital		
Off-Balance Sheet Items		
Unused loan commitments		
Letters of Credit		
Other Off-balance Sheet Items.		

Comparative Statement of Income

	Examination Date	Period Ended
Income Statement		
Interest Income		
Interest Expense		
Net Interest Income		
Non-interest income		
Total non-interest expense		
Provision for Loan and Lease Losses		
Securities gains (losses)		
Net Operating Income (pre-tax)		
Applicable Income Taxes		
Net Operating Income (after tax)		
Extraordinary credits (charges) net		
Net Income		
Other increases/decreases		
Cash Dividends		
Net change in equity Accounts		
Ratios		
Net Interest income/average earning assets		
Total non-interest expense/average assets		
Net income/average total equity		
Net losses/average total loans and leases		
Earnings coverage of net losses X		
ALLL/Total loans and Leases		
Nonperforming/ALLL		

Reconcilement of Allowance for Loan and Lease Losses

	Examination Date	Period Ended
Beginning Balance		
Gross Loan and Lease Losses		
Recoveries		
Provision for Loan and Lease Losses		
Other increases (decreases)		
Ending Balance		

|

Capital Calculations

	$(000's)	Date
Tier 1 Capital		
Common stock		
Surplus		
Undivided profits and capital reserves		
Foreign-currency-translation adjustments		
Noncumulative perpetual preferred stock and surplus		
Minority interests		
Subtotal: tier 1 capital elements		
Less:		
Ineligible intangibles		
Other adjustments		
Tier 1 capital		
Tier 2 Capital		
Allowance for loan and lease losses[1]		
Mandatory convertible debt		
Agricultural loss deferral		
Cumulative perpetual preferred stock		
Subordinated debt		
Other		
Tier 2 capital (not to exceed 100% of tier 1 capital)		
Total Tier 2 Capital		
Tier 1 plus tier 2 capital		
Less: deductions		
Total capital		

Summary of Items Subject to Adverse Classification

Adverse Classification

Include assets and off-balance sheet items that belong to the following categories:

Substandard Assets: A "Substandard" asset is inadequately protected by the current sound worth and paying capacity of the obligor, or of the collateral pledged – if any. "Substandard" assets must have a clearly defined weakness or weaknesses that jeopardize orderly liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets: Assets classified "Doubtful" has all the weaknesses inherent in one classified "Substandard" with the added characteristic that its weaknesses make collection or liquidation in full (on the basis of currently existing facts, conditions and values) highly questionable and improbable.

Loss Assets: This classification does not mean that the asset has no recovery or salvage value whatsoever. Rather, an asset classified as a "Loss" is considered uncollectible and/or of such little value that continued recognition as a bankable asset is not warranted under current market conditions.

Thousands IRD

Assets category	**Substandard**	**Doubtful**	**Loss**	**Total**
Loan portfolio				
Securities				
Accounts receivable				
Other assets (off balance sheet, etc.)				
Total as of exam date				
Total as of previous exam date				

	Category		
Amount, description, comments	Substandard	Doubtful	Loss

Summary of Items Special Mention

A **Special-Mention Asset** has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

|

	Exam date	**Previous exam date**
Total "Special Mention" assets		

Description, comments	**Amount**

Loan Distribution

Category	**Amount**	**Percent**
Real Estate Loans		
Installment Loans		
Commercial Loans		
Other Loans and Leases		
Total Gross Loans and Leases		

PAST-DUE LOANS AND LEASES

Category	30-89 Days	90 or More days	Total	Total Past Due/Outstanding
Real Estate Loans				
Installment Loans				
Commercial and other Loans				

Non-Accrual Loans

Category	Past due & Accruing Interest	Past Due & On Non-accrual	Total Past Due	Non-Accrual/Total Past Due
Real Estate Loans				
Installment Loans				

Commercial and other Loans				

ASSETS WITH CREDIT-DATA OR COLLATERAL-DOCUMENTATION EXCEPTIONS

Includes assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the Deficiency column.

|

1 -- Appraisal
2 -- Title Search or Legal Opinion
3 -- Borrowing Authorization
4 -- Recordation
5 -- Insurance
6 -- Collateral Assignment
7 --
8 --

Name or Description	**Amount**	**Date of Most Recent Financial Statement**	**Deficiency Number(s) or Description**
Total			
Percentage of Total Loans			

SIGNATURE OF DIRECTORS

We, the undersigned directors of _____ , have personally reviewed the contents of the report of examination dated _____ .

Signature of Directors	**Date**
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

NOTE: This form should remain attached to the Report of Examination and be retained in the institution's file for review during subsequent examinations. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

CONFIDENTIAL SECTION

CONFIDENTIAL SECTION -DIRECTORS

Name[1]	Year of Birth	Year Elected to Board	Occupation or Principal Business Affiliation
_____	_____	_____	_____

[1] Number of meetings missed of a total of _____ held since the previous examination. Regular schedule of directors' meetings:

Fee paid each director:

CONFIDENTIAL SECTION - EXECUTIVE OFFICERS

Name and Title	Area of Responsi-bility	Year of Birth	Years in Present Position	Salary (S) Bonus (B)
_____	_____	_____	_____	_____

CONFIDENTIAL SECTION-MANAGEMENT AND CONTROL

1. Discuss any other relevant matters regarding the bank's management not previously addressed.

2. If the bank is in a weakened or extended condition, what aid may be expected from shareholders or others?

3. List each major shareholder (5 percent or more) of the bank and the respective percentage of ownership. When the major shareholder is a bank holding company, list its major shareholders and the percent controlled.

Shareholders	**Percentage Owned**

4. Comment on the extent to which a particular director(s), shareholder(s), or executive officer(s) controls or dominates the bank's policies and operations.

5. Comment on any adverse effects of insiders on operating policies, procedures, or overall financial condition of the bank.

6. Provide the aggregate amount of borrowings by directors, executive officers, principal shareholders, and their related interests. Describe any material loans or other transactions between the bank and its executive officers, directors, or its direct or indirect principal shareholder(s) and their interest(s), and assess the impact of the transactions on the bank. (An interest would include any holding company affiliate or outside business interest or a bank or holding company insider in which 25 percent or more is controlled.)

7. Has any director, officer, or employee allegedly embezzled, abstracted, or otherwise criminally misused the funds of the bank since the previous examination? If so,

have proper authorities been notified? If proper authorities have not been notified, explain why.

CONFIDENTIAL SECTION -RATING AND GENERAL INFORMATION

1. State the bank's rating at this examination and the date of the rating at the last examination. Briefly discuss the rationale for the rating and reasons for any departures from Central Bank of Iraq implementing guidelines with respect to the CAMEL component ratings and the composite rating.

2. Discuss future prospects of the bank.

3. Was a meeting held with the full board of directors to discuss matters subject to criticism? If not, give names of directors and officers with whom the bank's condition was discussed.

4. Indicate the number of examiner days to complete the pre-examination, on-site, and post-examination work.

Name	On Premises	Off Premises

Ліцензія № _____

I. STATISTICAL DATA

Bank _____ Town_____
Legal address of the bank _____
License № _____ Date of issuance _____
Number of branches _____
Major shareholders_____Form of ownership_____

ITEM	1	2	3	4
Examination date				
Examination type				
Examiner-in-Charge				
Composite Rating				
Component Ratings (CAMEL)				
	Thous. Dinars			
Total Assets				
Total Loans				
Actual Loan Loss Reserve				
Required Loan Loss Reserve				
Total Past Due				
Total Past Due/Gross Loans				
Special Mention Loans				
Total Classified Assets				
Substandard				
Doubtful				
Loss				
Classified assets /Total assets				
Classified assets - Reserves/Capital				
Loan coverage (%)				
Total insider loans				
Accounts receivable				
Actual Loss Reserve				
Required Loss Reserve				
Securities				
Actual Loss Reserve				
Required Loss Reserve				
Fixed Assets				
Total Liabilities				
Individual Deposits				
Inter-bank (borrowings)				
Total Capital				
Tier I capital				
Tier II capital				
Total Capital/Risk weighted assets (%)				
Total Capital/Total assets				
Interest income				
Interest expense				
Net Interest Margin (NIM)				
Results of operations (Profits after taxes)				

Return on assets (ROA)				

INSTRUCTIONS FOR STATISTICAL DATA SHEET

The Statistical Data sheet provides basic information about the bank under examination. It is an internal document of the CBI to be used at the preparation of future examinations, which should not be presented to the bank. All financial information should reflect any adjustments made during the examination. The Statistical Data sheet must be completed for every on-site examination, regardless of scope, and should accompany every Report of Examination. Numbers reflected in the statistical data sheet should reconcile with numbers used in the text and schedules of this report.

The information for the most current examination should be entered in column **4**. Information from the previous examinations should be shifted to columns **1**, **2**, and **3**, with information from the most recent previous examination in column **3**.

The instructions provided below must not be altered in any way. All data fields must be complete. If a value is zero, a 0 should be entered. If a field is not applicable, NA should be used in the appropriate data field. All information should be identical to the information used in the report of examination.

Name of Bank – Full corporate (legal) name.

City - The city where the head office is located.

Head Office Location – The address (including number and street) of head office.

License # - The number of the license permitting the bank to conduct business.

Date License Issued – The date the license was issued.

No. of Branches – The number of balance sheet branches.

Ownership – Principal (or largest) shareholder and percent of ownership.

Examination Date – The date of financial information used for the examination

Type of Inspection – Full Scope (Comprehensive) inspection **= FS**
Targeted inspection **= Target**

Examiner-in-Charge – Family name of the Examiner in Charge.

Composite Rating – The composite rating assigned to the bank based on the findings of the inspection.

Component Rating (CAMEL) – The component ratings assigned to the bank based on the findings of the examination, e.g. 2/3/3/3/2 (CAMEL).

Total Assets – Total assets in thousand Dinars net of inter-branch activity and reflective of adjustments made during the examination, e.g. charge-offs, reserves, accounting errors, etc.

Total Loans – The sum of all loans: business, government, individual, factoring, credit card, etc., reflective of adjustments made during the examination.

Actual Loan Loss Reserve – The loan loss reserve stated on the bank's books reflective of adjustments made during the examination.

Required Loan Loss Reserve – The loan loss reserve required by current CBI resolutions.

Total Past Due & Extended or Prolonged Loans – The total of past due and prolonged loans reflective of adjustments made during the examination.

Past Due Loans – The total of past due loans reflective of adjustments made during the examination.

Prolonged Loans – The total of extended or prolonged loans reflective of adjustments made during the examination.

Special Mention Loans – The total of loans listed as special mention during the examination.

Total of Classified Assets – The total of Substandard, Doubtful and Loss assets identified during the examination.

Substandard – Total of all assets determined Substandard during the examination.

Doubtful – Total of all assets determined Doubtful during the examination.

Loss – Total of all assets determined Loss during the examination.

Classified assets/Total assets – **Total classified assets** (see above)/**Total assets** (see below)

Total Classified Assets - Reserves as % of Total Capital – **Total of Classified Assets** (see above) minus **Actual Loan Loss Reserve** (see above).as a percent of **Total Capital** (see below).

Loan Coverage (%) – The total of all loans reviewed during the inspection as a percent of **Total Loans** (see above).

Total Insider Loans – The total of all loans and guarantees to insiders as defined in current CBI resolutions.

Accounts Receivable – The total of all accounts receivable reflective of adjustments made during the inspections.

Actual Reserve – The accounts receivable reserve stated on the bank's books reflective of adjustments made during the examination.

Required Reserve – Accounts receivable reserve required by current CBI resolutions.

Securities – Total sum of securities with the consideration of adjustments made in the course of the examination.

Actual Reserve – The security reserve stated on the bank's books reflective of adjustments made during the examination.

Required Reserve – Security reserve required by current CBI resolutions.

Fixed Assets – The total of fixed assets reflective of adjustments made during the inspection.

Total Liabilities – The total of liabilities net of inter-branch activity reflective of adjustments made during the inspection.

Individual Deposits – The total of all deposits, term and demand, to individuals.

Inter-bank Borrowings – The total of all borrowings from other banks, foreign and domestic.

Total Capital – The sum of capital as defined under current CBI resolutions and reflective of adjustments made during the examination.

Tier 1 Capital – Tier 1 Capital as defined under current CBI resolutions and reflective of adjustments made during the examination.

Tier 2 Capital – Tier 2 Capital as defined under current CBI resolutions and reflective of adjustments made during the examination.

Total Capital/Risk Based Assets (%) – **Total Capital** (see above) as a percent of Risk Based Assets as defined in current CBI resolutions.

Total Capital/Total Assets (%) – **Total Capital** (see above) as a percent of **Total Assets** (see above).

Interest Income – Sum of year-to-date interest income from all sources and reflective of adjustments made during the examination.

Interest Expense – Sum of year-to-date interest expense from all sources and reflective of adjustments made during the examination.

Net Interest Margin (NIM) – Interest Income less Interest Expense as a percent of Average Earning Assets.

Results of operations – The result of operations (Profits after taxes) reflective of adjustments made during the examination

Return on Assets (ROA) – **Results of operations** (Profits after taxes) (see above) as a percent of **Total Assets** (see above).

INTRODUCTION

The purpose of a risk assessment approach, or **CAMEL** rating system, is to determine in a comprehensive and uniform manner a bank's overall condition. Such a uniform rating system will help identify those banks whose financial, operational and managerial weaknesses constitute a significant risk of failure and require special supervisory attention or, if necessary, Central Bank of Iraq (CBI) intervention to deal with serious weaknesses.

A uniform rating system allows the CBI to assess the aggregate strength and soundness of the financial industry and the soundness of risk management practices. This assessment of systemic risk provides critical information in determining bank supervision priorities, and the resources needed to properly supervise the banking industry.

The rating system requires a thorough analysis of a bank's condition. This analysis can only be carried out during full scope onsite examinations where significant verification of assets and transactions take place. Additionally, only during onsite examinations can the examiners truly understand management's tolerance for risk and risk management approach.

The rating system is based on a risk assessment approach, which places emphasis on five key components:

Capital Adequacy

Asset Quality

Management

Earnings

Liquidity

Each commercial bank is assigned a uniform composite rating (**CAMEL** rating) that is based on the evaluation of the five key components. A rating system provides a general framework for evaluating all significant managerial, financial, and operational factors for each commercial bank supervised by the CBI.

A sixth component (S) for Sensitivity to Market Risks is habitually used, but CBI chose not to take it into consideration at this stage, as several of its elements do not apply to Iraqi banks.

Assignment of a **CAMEL** rating is a standardized method of assessing banks and its efficiency depends on the qualifications and objectivity of examiners who routinely conduct examinations and assess the risk in banks.

After concluding the CBI examination of all banking functions, a Report of Examination is prepared in a uniform format where all **CAMEL** components are determined. Disclosure of component ratings to a bank's board of directors and senior management should strengthen communications by encouraging more complete and open discussions of examination findings, conclusions and recommendations. This should provide management and the board of directors a better understanding of how

composite ratings are derived, enable management to better focus attention on possible areas of weakness and timely corrective measures. CAMEL ratings are considered confidential by the Central Bank of Iraq and will not be disclosed to any public media. However, component and composite ratings will be disclosed within full scope reports of examination. Bank board members and senior management should ensure that the confidentiality of the rating and the report of examination are maintained.

Main Provisions

The uniform rating system requires that each bank be assigned a numerical rating based on five key components. Each component is assigned a numerical rating of "1" through "5". A "1" rating indicates the highest rating, strong performance and risk management practices, and the least degree of supervisory concern, while a "5" indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern. . Based on the ratings of each key component, a composite rating of "1" through "5" is assigned to the bank. All factors, as reflected in the key component ratings, are considered in assigning the composite rating. The composite rating assigned is not an arithmetic average of the component ratings, but is based on a qualitative analysis of the factors comprising each component, the interrelationship between components, and the overall level of supervisory concern about the bank. Evaluation of the components should take into consideration the institution's size and sophistication, the nature and complexity of its activities, and risk profile. Because the process for determining a composite rating is subjective, considerable judgment and support is needed to assess a composite rating. There should be no fractional composite ratings.

Banks with a composite rating of "1" are sound in all aspects, generally have components rated 1 or 2 and are in substantial compliance with laws and regulations. Any weaknesses can be handled routinely by the board of directors and management. Banks are considered stable, well managed and capable of withstanding all but the most severe economic downturns. Risk management practices are strong and minimal supervisory oversight is required to ensure the continuation and validation of the bank's fundamental soundness. Banks rated "1" give no cause for supervisory concern.

Banks with a composite rating of 2 are fundamentally sound; generally no component is rated higher than "3", and is in substantial compliance with laws and regulations. Only moderate weaknesses are present and well within the capabilities of the board of directors' and management's capability and willingness to correct. These banks are stable and can withstand most economic downturns. Overall risk management practices are satisfactory and there are not material supervisory concerns. Supervisory response for "2" rated banks should be informal and limited.

Banks rated "3" generally have weaknesses in one or more component areas that if not corrected within a reasonable time frame could result in significant solvency or liquidity concerns. Management may lack the ability or willingness to effectively address weaknesses in a timely manner and these banks generally are less capable of withstanding business fluctuation and are vulnerable to outside influences. Risk management practices may be less than satisfactory and banks in this group may be in significant noncompliance with laws and regulations. The CBI should consider the

need for administrative actions, which provide clear guidance to management in addressing weaknesses. Failure appears unlikely, however, given the overall strength and financial capacity of these banks.

Banks rated "4" indicate serious unsafe and unsound practices and serious financial or managerial deficiencies that result in unsatisfactory performance. The board of directors and management is not satisfactorily resolving the weaknesses and problems. Risk management practices are generally unacceptable and there may be significant violations with laws and regulations. Problems range from severe to critically deficient and require close supervision and specific remedial action. The overall solvency of the bank is threatened if immediate and specific supervisory action is not taken.

Banks rated "5" exhibit extremely unsafe and unsound practices or conditions, critically deficient performance and their risk management practices are inadequate. The volume and severity of problems are beyond management's ability or willingness to control or correct. Failure is highly probable and immediate outside financial or other assistance is needed and on-going supervision is necessary.

To assign a composite rating to banks, which have branches, the CBI will use material gathered from examinations conducted in significant branch offices. These conclusions will then be incorporated into a consolidated Report of Examination. Examination conclusions should be finalized not later than 14 days from when the examination has been finished.

Criteria of main assessment indicators.

The following criteria are to be used to assign individual component ratings.

Capital Adequacy

Capital is rated based on full consideration of the following factors:

- Nature and extent of risks to the bank and management's ability to identify, measure, monitor and control these risks;
- Nature, trend and volume of problem assets in relation to total capital and adequacy of loan loss and other reserves;
- Balance sheet composition, including the nature and amount of off-balance sheet assets, market risk, concentration risk;
- Business activities, e.g. local, regional, national, or multinational;
- Asset and capital growth experience, plans, and prospects;
- Earnings performance, reasonableness of dividends, and capital requirements;
- Access to capital markets and other sources of capital;
- Compliance with regulatory requirements; and
- Strength of management in relation to the above factors.

1. A bank with capital rating of "1" is characterized by:

   天 Capital levels and ratios exceed all regulatory requirements;

   天 Strong earnings performance;

   天 Well managed growth;

   天 Management is well versed in the bank's business activities and analyzes the risks associated with these business lines in determining appropriate capital levels;

   天 Dividends are reasonable and the ability of shareholders or holding company to increase capital is not a concern; (reasonable dividends are those which provide a return to shareholders without impeding required capital growth)

   天 A low volume of problem assets.

2. A bank with capital rating of "2" has similar characteristics as a "1" rated capital; capital and solvency ratios of a bank exceed regulatory requirements but the bank is experiencing weaknesses in one or more of the above factors. For example, a bank may have strong earnings and have well managed growth, but the volume of problem assets is relatively high but does not exceed 25% of total capital; management fails to maintain sufficient capital to support the risk inherent in the bank's business lines. These weaknesses can be corrected within reasonable time frames without close regulatory oversight.

3. A bank with a capital rating of "3" complies with capital adequacy and solvency regulatory requirements but displays major weaknesses in one or more of the above factors. Capital rated "3" usually requires regulatory oversight to ensure management and/or the shareholders properly address issues of concern and take the necessary steps to improve capital adequacy. Reasons for rating capital 3, such as a high level of problem assets which exceed 25% of total capital, poor earnings, unmanaged asset growth, etc. are significant enough that if corrective action is not taken in a timely manner, capital levels could deteriorate to the point of insolvency. Additionally, a capital rating of 3 should be considered if the bank significantly fails regulatory requirements, shareholders cannot provide additional capital to meet regulatory requirements.

4. A bank with capital rating of "4" is experiencing severe problems resulting in inadequate capital to support risks associated with the bank's business lines and operations. The bank usually has a high level of loss making problem loans, which exceed 50% of total capital, is experiencing large losses from security, foreign exchange or credit operations, and/or realizing substantial negative earnings. The bank may or may not experience failure of regulatory requirements, but it is obvious there is insufficient capital. If management and/or shareholders do not take immediate action to correct deficiencies, imminent insolvency is expected. Strong regulatory oversight is required to ensure management and/or shareholders take appropriate actions to improve capital adequacy.

5. A bank with capital rating of "5" is considered insolvent. Strong regulatory oversight is needed to mitigate losses to depositors and creditors. Losses from securities, foreign exchange or credit operations approximate or exceed total

capital. There is only a slight possibility that management's and/or shareholders' actions will prevent the total failure of the bank.

Asset Quality

Asset quality is rated based on the full consideration of the following factors:

- Volume and severity of problem assets to include loan and investment portfolios, other real estate owned, and other assets as well as off-balance sheet transactions in relation to total capital;
- Volume, distribution, severity and trends of overdue and prolonged loans; classified, non-accrual, restructured and nonperforming assets for both on- and off-balance sheet transactions;
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets;
- Large concentrations and risk to one borrower or related borrowers;
- Volume and management's treatment of loans to insiders;
- Efficiency of loan portfolio management with regard to strategies, policies, procedures, practices, internal controls and management information systems;
- Credit related legal activity (claims, chasing borrower etc.);
- Level of loan loss reserves in relation to problem credits and other asset valuation reserves; and
- Quality, volume, trends, diversification and management of other assets, e.g. investment securities, fixed assets, bills of exchange, etc.;
- Exposure to counter party, issuer, or borrower default under actual or implied contractual agreements.

1. A bank with asset quality rated "1" is characterized by:
    - Volume of problem assets in relation to capital is usually less than 10%;
    - Positive or stable trends in the volume of overdue and prolonged loans;
    - Concentrations of credit and loans to insiders are well controlled and provide minimal risk;
    - Loan portfolio management is efficient, effective and well controlled, i.e. strong underwriting standards, close monitoring and management of problem credits, appropriately controlled loans to insiders, etc.;
    - Management maintains adequate or more than adequate reserves for loan losses; and
    - Other assets (non-credit) of the bank possess normal banking risk and pose no threat of loss.

2. A bank with asset quality rated "2" displays similar characteristics as a "1" rated asset quality, but is experiencing weaknesses or deficiencies in one or more of the

above factors. The weaknesses or deficiencies are not significant and management is able to address these without close regulatory oversight. A "2" rated asset quality may be characterized by the volume of problem assets usually not exceeding 25% of total capital and one or more of the following characteristics:

- The bank is experiencing negative trends in the level of overdue and prolonged credits and/or loan loss reserves;
- There are weaknesses in management's underwriting standards and control procedures;
- Loans to insiders pose some regulatory concern but are easily corrected; and/or
- Return on non-credit assets is low and they display more than normal risk, but do not pose threat of loss.

3. A bank with asset quality rated "3" displays major weaknesses in one or more of the above factors. Regulatory oversight is required to ensure management appropriately addresses weaknesses and deficiencies. A "3" rated asset quality may be characterized by the volume of problem assets exceeding 25% of total capital and one or more of the following characteristics:

- The bank is experiencing high levels of overdue and prolonged credits;
- Inadequate loan loss reserves;
- Poor underwriting standards and lax control procedures;
- Inappropriate and preferential loans to insiders; and/or
- Non-credit assets display more than normal risk and may pose a threat of loss.

4. A bank with asset quality rated "4" displays major weaknesses that if not immediately corrected will result in capital impairment or insolvency. Strong regulatory oversight is needed to ensure management takes immediate steps to address weaknesses and correct deficiencies. A "4" rated asset quality is characterized by the volume of problem credits exceeding 50% of total capital and one or more of the following characteristics:

- Level of problem credits continues to increase resulting in impaired capital and could result in insolvency if not controlled;
- Severely classified (doubtful and loss-making) credits far exceed reserve for loan losses and poses a threat to capital; and/or
- Non-credit assets pose major loss of capital and may result in the bank's insolvency.

5. A bank with asset quality rated "5" displays a high level of problem assets that severely impairs capital or results in a negative capital position. Strong regulatory oversight is needed to prevent further capital erosion and/or to protect depositors and creditors. There is only a slight possibility that management's actions will be successful in improving the quality of the bank's assets.

Management

The quality of management is the single most important element in the successful operation of a bank, and is usually the factor that is most indicative of how well risk is identified, measured, monitored and controlled. Management is rated based on the full consideration of the following factors:

- The level and quality of oversight and support of the bank's activities by the board of directors and management;
- The ability of the board of directors and management to understand, plan and respond to the risks associated with the bank's activities in the current or future economic environment or initiation of new products or activities;
- Financial performance of the bank with regards to asset quality, capital adequacy, earnings and liquidity;
- Development and implementation of plans, policies, procedures and controls for all major areas;
- Availability and adequacy of internal and external audit function and their ability to promote effective operations, reliable financial and regulatory reporting and the safeguarding of assets;
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems;
- Compliance with legislation and regulations of the CBI;
- The extent that the board of directors and management is affected by or susceptible to dominating influence, concentration of authority or tendency toward self-dealing;
- Roles and interactions of the managing bodies, Board of Directors and shareholders;
- Depth, succession and reasonableness of compensation policies;
- Response to CBI concerns and recommendations; and
- The overall performance of the bank and its risk profile.

1. Management rated "1" is characterized by:
   - A thorough understanding of the risks associated with the bank's activities;
   - Average to strong financial performance in all areas;

- Appropriate understanding and response to a changing economic environment;
- Reasonable planning, policies, procedures and controls (actively monitoring compliance);
- An appropriate audit function;
- No evidence of self dealing;
- Managers and the Board of Directors working closely together;
- Reasonable management depth, succession and training; and
- Management and the Board of Directors responsive to CBI concerns and recommendations.

2. Management rated "2" have similar characteristics as a "1" rating but possess some deficiencies that are easily corrected without regulatory supervision. Moderate concerns in one or more of the above areas would warrant a "2" rating. Careful consideration should be given to the bank's financial condition and other mitigating circumstances in differentiating between a "1" and "2" rated management.
3. Management rated "3" displays major weaknesses in one or more of the above factors. Regulatory supervision is required to ensure management or the Board of Directors takes corrective action. A "3" rated management is usually characterized by significant insider abuse, disregard for regulatory requirements, poor assessment of risk and planning processes for the bank's business lines, inappropriate reactions to economic adversities, and/or poor financial performance.
4. Management rated "4" displays major weaknesses in a number of the above factors. Strong regulatory action is needed to ensure corrective action. The CBI or Board of Directors should consider measures to replace or strengthen management. A "4" rated management is considered when there is widespread insider abuse, total disregard for regulatory requirements, or management's actions have damaged the financial performance to the point where the bank is facing potential insolvency.
5. Management rated "5" is totally ineffective and requires immediate and strong supervisory actions. Normally a bank with management rated "5" displays weaknesses in most of the above factors and the bank is experiencing extremely poor financial performance. The CBI or the Board of Directors should be considering receivership or the immediate replace of management.

Earnings

Earnings are rated based on the full consideration of the following factors:

- Earnings sufficient to cover losses, provide adequate capital, and pay reasonable dividends;
- Quality and composition of net income, including the effect of taxes;
- Volume, trends and stability in various components of net income;
- Level of expenses in relation to operations;
- Reliance on extraordinary items, securities transactions, high risk activities, or non-traditional sources of income; and
- The adequacy of budgeting, forecasting, planning, control and management information systems of income and expense items;
- The adequacy of provisions to maintain the loan loss reserve and other asset valuation reserves;
- The earnings exposure to market risk such as interest rate, foreign exchange and price risk.

Often profitability ratios are established to help in the rating process. These ratios are based on the performance of banks with similar characteristics. Although ratios are important, the above factors should weigh heavier than comparisons to a standard profitability ratio. For example, a bank may reflect very strong earnings, but the source of earnings is from a one-time event or high-risk non-traditional activities. Also, despite a high profitability ratio, earnings retention is still inadequate to allow the growth in capital to keep pace with asset growth.

1. A bank with earnings rated "1" is characterized by:

   - Sufficient income to meet reserve requirements, provide for capital growth (earnings retention) and pay dividends reasonable for shareholders needs;
   - Strong budgeting, planning and control of income and expense items;
   - Positive trends in major income and expense categories;
   - Minimal reliance on extraordinary items and non-traditional sources of income; and

2. A bank with earnings rated "2" generates sufficient income to meet reserve requirements, provide for capital growth and pay reasonable dividends. However, the bank may be experiencing negative trends, beginning to rely on extraordinary income to increase net profit, and/or management needs to improve their budget,

planning or control processes. Management should be able to address these weaknesses without regulatory supervision.

3. A bank with earnings rated "3" displays major weaknesses in one or more of the above factors. Usually, regulatory supervision is required to ensure management takes appropriate steps to improve the bank's earnings performance. The bank may be experiencing declining earnings performance through management's actions or inaction that impede the formation of reserves or provide sufficient earnings retention. If allowed to continue, the bank may develop an impaired capital position.

4. A bank with earnings rated "4" is experiencing severe earnings problems. Net profits may be positive, but insufficient to maintain adequate reserves and required capital growth. Strong regulatory supervision is necessary to strengthen the earnings performance and prevent loss of capital. Management must take immediate action to improve income and control expenses. This may require the CBI to require Managers and Board of Directors to reduce asset growth by suspending certain banking activities. Without immediate corrective action, losses may develop that might threaten the bank's solvency.

5. A bank with earnings rated "5" is experiencing losses that jeopardize the solvency of the bank. Immediate and strong regulatory supervision is needed to effect corrective actions. Without immediate action, losses will result in imminent insolvency.

Liquidity

Liquidity is rated based on the full consideration of the following factors:

- Volume and source of liquid funds (assets readily convertible to cash without undue loss) available to meet the bank's daily obligations without adversely affecting its operations or condition;
- Volatility and trends of deposits and loan demand;
- Interest rates and maturities of assets and liabilities (Gap Analysis);
- Access to money markets and other sources of funds;
- The level of diversification of funding sources, both on- and off-balance sheet;
- Reliance on inter-bank borrowings and other volatile short-term funding to meet liquidity needs; and
- Management's ability to plan, control, measure and monitor the bank's liquidity processes (management information systems) and contingency funding plans.

- Diversification of funding sources.

One of management's major responsibilities is to maintain sufficient liquid assets to meet daily obligations, while maximizing earnings and minimizing risk. This responsibility requires a thorough knowledge of the bank's balance sheet, clientele base (loans and deposits), and economic environment. Management, who maintains a high level of liquid assets, usually takes on less risk and experiences lower earnings. Conversely, management who maintains low levels of liquid assets experiences strong earnings, but have generally greater volumes of high-risk assets. Management who maintains the bank's liquidity thorough borrowings or a combination of liquid assets and borrowings, requires a high level of sophistication in its managing of assets and liabilities.

1. A bank with a liquidity rating of "1" is characterized by management having a thorough understanding of the bank's balance sheet, clientele and economic environment;

   - Sufficient liquid assets to meet routine and unexpected deposit volatility and loan demand;
   - Nominal reliance on inter-bank borrowings for liquidity needs; and
   - Strong planning, controlling and monitoring processes.
   - Management possesses sufficient expertise to profitably use inter-bank borrowings to meet liquidity needs; and
   - Employs sophisticated planning, control and monitoring processes.

2. A bank with a liquidity rating of "2" has similar characteristics as a "1" rated liquidity but is experiencing weaknesses in one or more of the above factors. These weaknesses can be corrected within reasonable time frames without close regulatory supervision. For example: The bank meets its liquidity needs but management lacks appropriate expertise or effective plans, controls and/or monitoring processes. Or, the bank may have experienced liquidity concerns and management reacted appropriately, but they failed to take the necessary steps to prevent recurring liquidity concerns. Or, management may be unaware or have not appropriately addressed negative trends (e.g. decreasing level of liquid assets, increasing deposit volatility, increased reliance on inter-bank borrowings, etc.).

3. A bank with a liquidity rating of "3" displays major weaknesses in one or more of the above factors. Regulatory supervision is usually required to ensure management appropriately addresses concerns. A "3" rated liquidity is characterized by an unsophisticated approach to liquidity management resulting in frequent liquidity concerns; management needs to immediately address negative trends to prevent a crisis in the bank's ability to meet daily obligations.

4. A bank with a liquidity rating of "4" is experiencing severe liquidity problems which require immediate and strong regulatory supervision. Actions must be taken to strengthen the liquidity position to ensure the bank meets its current obligations. Management must engage in extensive planning to deal with short term and unexpected liquidity needs.

5. A bank with a liquidity rating of "5" requires CBI or outside financial assistance to meet current liquidity needs. Such immediate assistance is needed to prevent the failure of the bank due to its inability to meet creditor and depositor demands.

Approval Process and Signature Authority

A formal approval process and signature authority is needed to ensure banks are assigned composite ratings on a consistent basis. A bank should receive a composite rating based on the results of a full scope onsite examination.

The rating should be maintained until the next full scope onsite examination. The composite rating can be changed only if extreme financial deterioration or improvement is identified during an offsite analysis. Such changes would be made only after close consultation with the onsite examiner assigned to the bank, the appropriate approval of the Deputy Governor with supervision oversight, the Director of Supervision and the Offsite department management.

The Report of Examination and the composite rating are approved at an appropriate bank supervision level (by the Director of the Bank Supervision Department and the Deputy Governor with supervision oversight responsibilities).

Proposed Composite Ratings of "1" or "2":

1. The Department of Bank Supervision should prepare the Transmittal letter addressed to the Chairman of the Board of the bank with a brief analysis of the Bank's condition, comments on each rating component with conclusions and concrete propositions for the elimination of deficiencies revealed by the examination and the development of corrective measures. The Report of Examination, composite and component ratings should then be reviewed and approved by the Director of Bank Supervision and the Deputy Governor with supervision oversight responsibilities. Copies of the Report of Examination and the Transmittal letter should then be sent to the Chairman of the Board of the bank, and a copy should be filed within the Supervision Department.

In some instances, for example - when the examination has revealed continued failure of management to address issues within the reports of examination, a Warning Letter may be presented to the bank together with the Report of Examination.

2. Appropriate employees of the Department of Bank Supervision shall be responsible for follow-up control of the commercial bank.

Proposed Composite Ratings of "3", "4" or "5":

1. When a bank is rated "3", "4", or "5"; or the examiner-in-charge is considering down grading a "1" or "2" rated bank to "3", "4", or "5", the Director of the Bank Supervision Department (or designee) should be consulted as to appropriate enforcement action.

2. The Report of Examination and enforcement action (if any) should be prepared by the examiner-in-charge of the onsite examination in the approved format and submitted to the Department of Bank Supervision management and senior CBI management for their approval.

3. Representatives of the Department of Bank Supervision should hold a meeting with the members of the Board of Directors of the commercial bank to discuss the results and findings of the examination and to present the Report of Examination and enforcement action (if any) for their signatures.

Proposed Composite Rating of "4" or "5" :

1. The Report of Examination and recommendations on the methods of supervision should be approved by the examiner-in-charge prior to submission to the departmental management.

2. The Director of the Bank Supervision Department shall submit the Report of Examination and methods of supervision for final approval to senior CBI manager.

3. If enforcement measures are being planned, the Department of Bank Supervision, on the basis of the Report of Examination and conclusions of the appropriate bank supervision departments and the CBI senior management, prepares a draft resolution for the CBI Board.

The Use of the Report of Examination

After its preparation, the Report of Examination is provided to the Board of Directors. Report comments on examination conclusions and comments should fully support the component and composite ratings assigned. It is then their responsibility to ensure that recommendations contained within the report and the transmittal letter are properly addressed.

Initial Rating

Within 90 days from the moment of the approval of this Policy, the Department of Bank Supervision should determine the rating for all banks, on the basis of onsite examinations or otherwise. The banks rated on the onsite basis will retain their rating. Remaining banks shall be rated on an offsite basis utilizing consultations with onsite examiners. This intermediate rating should be approved in compliance with Section IV of this Policy.

Central Bank of Iraq

Rating Matrix

Regulatory Capital

Rating--→	1	2	3	4	5
Issue: • RBC Capital Ratio	RBC Ratio > 15% of Risk Weighted Assets	RBC Ratio Between 12 – 15% of Risk-Weighted Assets	RBC Ratio Between 10 – 12% of Risk-Weighted Assets	RBC Ratio Between 8 – 10% of Risk-Weighted Assets	RBC Ratio Less than 8% of Risk-Weighted Assets
• Future Capital Availability	Future Capital is Available from Existing Sources - at least (--) Millions $	Future Capital is Available from Existing Sources – (--) to (--) Millions $.	Future Capital is Possible, but Sources not Identified at Present	Future Capital Depends upon Uncertain Future Events	Future Capital Injection is not Felt Possible.
• Growth in Capital	Growth in Assets is Controlled and Capital Growth Exceeds Asset Growth	Asset growth is generally planned, but currently exceeds capital growth	Asset growth is not planned.	Asset growth exceeds growth in Capital	Asset growth is significant in amount while capital growth is nil
• Trend in Capital	Bank has Historically Maintained Adequate Capital	Bank Generally has Adequate Capital, but looks to External Sources	Bank must Rely upon External Sources of Capital	Capital ratios have Historically Declined in Amount	Capital Amounts have been Declined Precipitously Over the Past 5 years.
• Fixed Assets (Including on and off balance sheet Leases)	Fixed Assets total less than 40% of Capital	Fixed Assets amount to 40-50% of Capital	Fixed Assets amount to 50-75% of Capital	Fixed Assets amount to 75-100% of Capital	Fixed Assets > 100% of Capital.
• Commitments and Obligations	Commitments and Obligations< 50% ofCapital.	Commitments and Obligations Between 50-65% of Capital	Commitments and Obligations total 65-80% of Capital	Commitments and Obligations Between 80% and 100% of Capital	Commitments and Obligations> 100% of Capital
• Ownership	Represents Strong, Stable Stockholders	Ownership Generally Supports	Ownership May be Able to Support – Amount is Uncertain	Ownership is Uncertain as to Amount and Timing	Ownership Support is not Likely. Bank may have to be Sold.

Central Bank of Iraq

Rating Matrix

Asset Quality

Rating--→	1	2	3	4	5
Issue: • Volume of Troubled (Classified) Assets *	Troubled Assets are Less than 20% of Capital - *	Troubled Assets Between 20-25 % of Capital *	Troubled Assets 25-50% of Capital *	Troubled Assets 50-75% of Capital *	Troubled Assets → 75% of Capital *
• Delinquent Loans	Delinquent Loans < 5% of Total Loans	Delinquent Loans 5-10% of Total Loans	Delinquent Loans 10-15% of Total Loans	Delinquent Loans 15-30% of Total Loans	Delinquent Loans > 30%
• Renewal Policies	Bank Renews Less than 5% of Loans	Bank Renews less than 10% of Loans	Bank Renews over 10% of loans coming due.	Bank Renews Routinely With Little Management of Practice	Bank has Little Option but to Renew Loans Consistently
• Loan Policies and Oversight	Bank has a Well Defined Loan Policy and Follows Same	Bank has a Loan Policy but does not always follow it	Bank has a Loan Policy, but it is weak and Needs Improvement	Bank has a Loan Policy, but doesn't follow it.	Bank Doesn't have a Loan Policy
• Growth	Loan Growth has been Moderate and Controlled	Recent Loan Growth is Strong, but Controlled	Loan Growth Over the last two years has been Heavy	Loan Growth Has been Consistently Heavy and Uncontrolled	Bank has a History of years of Heavy Loan Growth
• Asset Losses **	Bank has Written Off Few Losses and Has Limited "Loss" Assets	Loan Losses Have Not Exceeded .5% of Loans per year.	Annualized Loan Losses > .5% but less than 1% of Total Loans	Annualized Loan Losses > 1% but less than 1.5% of Total Loans	Annualized Loan Losses > 1.5% of Total Loans
• Concentrations of Credit ***	Bank Has Few Concentrations and Effectively Manages Same	Bank Has Several Concentrations. Little controls	Bank Has Concentrations but does not Recognize Same	Concentrations Exist with Evidence of Poor Performance Within Such Credits	Heavy Concentrations Exist – Performance Poor in Same
• Risk Management	Bank Knows the Volume and Severity of Problem Assets	Bank Generally Knows its Problem Assets	Inspection Revealed 25% increase in Classified Assets	Inspection Revealed 50% or more increase in Classified Assets	Inspection Indicated the Bank does not know its Classified Assets

Rating--→	1	2	3	4	5
• Reserves	Reserves are Strong Given Loss Potential	Reserves are Ok, for Losses Expected	Reserves are Just Moderately Adequate	Reserves are Inadequate in total.	Reserves are Inadequate and Bank is Unable to Estimate Needs

*** - Troubled Assets include all classified assets (substandard, doubtful and loss). Capital includes all book capital plus the reserve for loan losses.**

**** - Asset Losses include annualized write-offs – or, the total of all assets rated as "Loss".**

***** - Concentrations of credit includes direct and indirect extensions of credit to a single industry (or business area) in excess of 25% of capital. Capital is defined as indicated just above.**

Central Bank of Iraq

Rating Matrix

Earnings

Rating--→	1	2	3	4	5
Issue: • Level	Return on Assets (ROA) > 2.5 %	ROA between 1.50 and 2.5%	ROA between .5 and 1.5%	ROA between 0 and .5%	ROA is negative
• Qualitative Aspects	Earnings are Stable over time and result from recurring activities	Earnings are Generally Stable but Centered in non-recurring activities	Earnings are Erratic in Amounts over the Years	Earnings Result Largely from Non-Recurring Items	Same as 4 plus– but, profitability result solely from Non-Recurring Items
• Standards	Bank Follows Good Accounting Stand-ards. (International Accounting Standards)	Bank Generally Follows Good Accounting Practices, but weak-nesses Exist	Bank does not fully utilize "Accrual Accounting" for it's accounting reports.	Standards are weak in the area of Recognition of Loss Potential and estab-lishment of Reserves	Weaknesses in Accounting Records Results in Financial Statements being Unreliable
• Core Earnings	Earnings are generated largely from "Core" Net-Interest Earnings	Earnings are largely Supplemented by "Other" Fee Income.	Earnings Result Largely from Fee Income	Earnings Result Solely from Below the Line Income	Net Interest Income is Negative
• Efficiency	Net-Interest Income Exceeds Overhead Expense by 25%	Net-Interest Income Exceeds Overhead Expense by 15%	Net-Interest Income Exceeds Overhead Expense by 10-15%	Net-Interest Income Equals Overhead Expense or < 10% of Overhead	Overhead Expense Exceeds Net-Interest Income
• Budgets / Controls	Bank Has Excellent Budgeting and Control Operations	Bank Has a Budget, but Weaknesses Exist in Reporting and Control.	Bank has a 'Once-a-Year' Plan, but doesn't follow it.	Bank doesn't have a Plan	Same as 4, plus the bank does not control operating expense.
• Dividend Payments	Earnings Pay-out less than 30% of Income	Earnings Pay-out between 30-50% of Income	Earnings Pay-out 50-75% of Income	Earnings Pay-out 75-85% of Income	Earnings Pay-Out Exceeding 85% of Income

Central Bank of Iraq

Rating Matrix

Liquidity

Rating--→	1	2	3	4	5
Issue: • Overall Level	Undoubtedly Adequate	Felt to be Adequate	Marginally Adequate	Inadequate – Supported by Borrowing	Inadequate – Borrowings Critical
• Quantitative	Loans / Deposits < 60%	Loans / Deposits Between 60 – 70%	Loans / Deposits Between 70-75%	Loans / Deposits Between 75-80%	Loans / Deposits Exceed 80%
• Borrowing Capacity	Bank Has Standby Capacity to raise liquid funds equal to 20% of assets, if needed	Bank is Felt to Generally be able to Raise Funds totaling 10% of Assets or More	Bank has not Documented its access to Contingency Funds	Access to Contingency Funds is Limited to the Central Bank of Iraq	Bank does not have Access to Contingency Funds
• Asset Structure	The bank has good Asset "run-offs" to facilitate liquidity needs.	Bank has a Limited Amount of Asset "run-offs" consider-ing the nature of the asset mix	Assets are long-term, depreciated, or of poor quality. Support is limited.	Asset Portfolios provide Little Run-offs.	Assets are frozen and provide no support.
• Liability Structure	Liabilities are "core" in nature and stable.	Bank has a modest amount of "purchased" funds	Liabilities show some evidence of instability owing to maturities and sources.	10% of the Liability Mix is considered Volatile – Purchased Funds	Over 10% of the Liability Mix is Considered Volatile.
• Planning	Bank has Excellent Funds Management Plans	Bank Plans are Informal in Nature, but Seemingly Effective	Bank has few plans and Liquidity is something that Just "Happens"	Plans are Limited to Short-term Contingency Needs.	Bank does not plan nor Manage Liquidity Needs

Central Bank of Iraq

Rating Matrix

Management

Rating--→	1	2	3	4	5
Issue: • Systems	Management has all the Formal Policies Needed. Policies are Reviewed and Updated when needed.	Management has some Formal Policies – But, Revisions are Appropriate	Management has only Implied Policies – no Written Policies. Implied Policies Seem to Work	Bank has Few Policies and Compliance is Usually Poor	Bank lacks Policies and Systems/Operations are Poor.
• Compliance With Law	Bank Consistently Complies with Law and Regulatory Requirements. Systems for Compliance are Good	Bank Generally Complies with Requirements. Systems for compliance are ok.	Bank has few isolated and non-critical violations. Systems need improvement	Bank has multiple and substantive violations. Bank management recognizes deficiencies	Bank has major violations that can expose the institution and management to legal sanctions.
• Personnel Management	Bank management has adopted good personnel management standards.	Standards are reasonably good, but improvements are needed.	Bank lacks formal organization, remuneration, and job performance standards	Employee morale is poor associated with personnel management operations	Turnover is heavy, the bank lacks the necessary people, and personnel mgt is poor.
• Staffing	Staffing in all areas is sufficient. Personnel seem to be well trained and motivated.	Staffing is ok, but generally could be improved	Weaknesses Exist in Critical Areas such as Lending and Funds Management.	Bank is critically over or understaffed. Training is poor.	Lack of Proper Staff is Impacting the Overall Results of the Institution
• Delegation of Authority	Bank Management successfully delegates authority as appropriate.	Bank management generally delegates authority, but reserves much for senior management	Little delegation exists – Most of the critical issues are reserved for Senior Management	Senior Management makes all functional decisions.	NOT Utilized
• Accountability and Organization	Management Holds Personnel Accountable for their actions	Management Generally Holds Staff Accountable for their actions.	Personnel are not held accountable for actions. But, most bank results have	Evidence Exists that Personnel are not held Accountable for their Actions when Negative	Little Accountability Exists within the Institution.

Rating--→	1	2	3	4	5
			been positive	Results Occur	
• Contingency Plans	Sound Contingency Plans Exist for all Key Critical Positions	Some Contingency Planning Exists, but It tends to be Informal	Very Limited Contingency Planing Exists – Usually only for the CEO	No Contingency Plans Exist	Contingency Plans don't exist and Critical Needs Exist in Lending and Key Areas
• Strategic Thinking	Management Has an Excellent Grasp of Where the Bank is Expected to go over the Next 5 years including forecasts.	The CEO has a few long-range plans – asset growth and capital. But, not for all aspects of the bank.	Bank management has fairly limited long-term strategic plans. No forecasts, for example.	Senior management only has a "vision" of where the bank might go in the future.	Senior management has no clue to the future direction of the bank
• Risk-Management	Management does an excellent job in managing risks within the institution.	Management adopts the principals of risk-management, but could improve risk recognition some.	Management reacts – rather than anticipates. Management is slow to identify and control risks.	Management doesn't actively manage risks. Looks to regulators / auditors for this task.	Risk management is poor and critical problems exist within the institution.