



CENTRAL BANK OF
MONTENEGRO

Banking Supervision Department

GUIDELINES ON THE SELECTION OF AUDITORS HIRED TO CARRY OUT ASSET QUALITY REVIEW

Definitions

AQR – asset quality review;

Guidelines – Guidelines on the Selection of Auditors Hired to Carry out Asset Quality Review;

AQR Manual – CBCG Asset Quality Review Manual submitted by the CBCG advisor, and drafted against the background of the Asset Quality Review Phase 2 Manual, the European Central Bank's document of June 2018, adjusted to local specificities;

Workblock – an expression used to denote a working entity i.e. a phase of the entire process, in accordance with the AQR Manual;

Potential Auditor – auditor eligible in accordance with item 2 of these Guidelines;

AQR Auditor – auditor selected by the bank;

ECB – European Central Bank

Western Balkan Countries - Serbia, Montenegro, Bosnia and Herzegovina, North Macedonia, Kosovo and Albania.

Introduction

The Guidelines on the Selection of Auditors Hired to Carry out Asset Quality Review (hereinafter: the Guidelines) shall apply in the process of selecting potential auditors, in connection with the AQR implementation planned for 2020, in accordance with the CBCG Asset Quality Review Manual (hereinafter: the AQR Manual);

Potential auditors shall be eligible. Their eligibility shall be determined in accordance with item 2 of these Guidelines.

A bank shall be free to select one AQR auditor from a group of potential auditors, taking into account the technical and financial aspects of bids delivered, while also reviewing and taking into account the requirements of



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these Guidelines. The bank's selection of the AQR auditor shall be subject to prior approval of the CBCG.

The bank shall notify the CBCG in writing of the selected AQR auditor. The CBCG reserves the discretion to request additional clarification and documentation regarding the selected AQR auditor, as well as to refuse a request i.e. refuse to give its approval for the proposed AQR auditor, in which case the bank shall select another AQR auditor. The CBCG reserves the right not to give its approval for the selection of the AQR auditor in the following cases:

- Where the CBCG assesses that the proposed AQR auditor and the proposed team do not possess appropriate capacities and experience to perform the AQR at a satisfactory level of quality;
- Where the CBCG assesses that there is a potential conflict of interest for the proposed AQR auditor to perform the AQR (whether as a legal person or as an individual team member);
- Where any measures relating to prohibition of professional activity or penalty for economic transgression, etc. have been imposed against the proposed AQR auditor.

In its contractual relation with AQR auditors, the bank shall secure the possibility to, as appropriate or in accordance with the CBCG order, obtain all necessary data and information, insight into the details of the selection and activities of the AQR auditor on this project, as well as terminate the contractual relation in cases envisaged in the AQR Manual that primarily relate to inadequate provision of services by the AQR auditor and/or failure to meet prescribed conditions.

The bank and the AQR auditor shall be responsible for providing necessary safeguards in order to ensure the independence of the appraisal.

The CBCG shall produce separate guidelines to govern the issue of the selection of AQR appraisers, which shall be responsible for reviewing appraisals and where necessary carrying out valuation of bank's collateral – real estate that are part of the sample of assets that shall include apartments, commercial buildings, commercial facilities, ongoing investments, land of all types, and other collateral subject to appraisal.

Where the potential auditor comprises more than one entity (consortium) it shall provide all individual information for the purpose of viewing the fulfilment of the requirements of the Guidelines.



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Item 1

The task of the AQR auditor in accordance with the AQR Manual

The AQR auditor shall carry out the process in accordance with the CBCG AQR Manual, the drafting of which is underway, which will contain specific tasks and methodology for carrying out the asset quality review. It should be noted that the Asset Quality Review Phase 2 Manual published by the ECB in 2018 served as the basis for producing the AQR Manual and supporting documentation. The ECB Manual is adjusted to local institutional and legal frameworks as well as to the specificities of the Montenegrin market.

For the purposes of the initial estimate of expected efforts and defining the financial aspect of the bid, it is recommended that any potential auditors shall be governed by the requirements under the aforementioned ECB Manual, taking into account expected simplifications tailored to the local market.

Prior experience has shown that the process of sampling may largely influence the expected effort estimate by an auditor. Specifically, since in most cases it is not possible to review all exposures of a portfolio, sampling is performed in such a manner as to ensure that the selected sample is wide enough and representative. The manner of sampling is expected to be largely based on the sampling methodology as described in the ECB's Asset Quality Review Phase 2 Manual issued in June 2018. This means that the size of the sample will depend on the features and specificities of the portfolio of a specific bank, such as homogeneity of the portfolio, the risk of the portfolio, the total number of debtors and the level of debtor concentration. Bearing in mind that the sizes of the resulting samples will vary across banks, it is not possible to provide exact guidelines regarding the sample sizes for individual banks. Therefore, for the purposes of expected effort estimate by the auditor, it can be assumed that the review will cover at least 50% of credit risk weighted assets.

The estimate shall be carried out as at selected cut-off date, in accordance with the AQR Manual.

For the purposes of initial planning, the AQR auditors are expected to perform the activities in accordance with the indicative timeline presented in the table below:



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| Indicative timeline | Indicative activities |
|---|--|
| Preparatory activities (early April up to the end of August 2020) | Preparatory activities by the CBCG: Drafting and adoption of the AQR Manual and supporting questionnaires, selection and approval of portfolios, distribution of material to the banks, and other preparatory activities Preparatory activities by banks: Selection of AQR auditors, preparation of data and information in accordance with the CBCG instructions, and other preparatory activities |
| End of August 2020 | Direct examinations (on-site visits) commenced in all banks |
| September 2020 | Completion of Workblock 1 (Processes, policies and accounting (PP&A) review) per the bank |
| September 2020 – October 2020 | Completion of Workblock 2 (Loan tape creation and Data Integrity Validation (DIV)) |
| October 2020 | Completion of Workblock 3 (Sampling) |
| October 2020 – December 2020 | Completion of Workblock 4 (Credit file review) |
| October 2020 – January 2021 | Completion of Workblock 5 (Collateral and real estate valuation) |
| November 2020 – January 2021 | Completion of Workblock 7 (Collective provision analysis) |
| November 2020 – January 2021 | Completion of Workblock 8 (Fair value exposures review) |
| January 2021 | Completion of Workblock 6 (Projection of findings of credit file review) |
| February 2021 | Completion of Workblock 9 (AQR-adjusted CET1% ratio) |
| March 2021 | Consideration of the draft report with banks |
| March 2021 | Delivery of final reports for all banks to the CBCG |

It should be noted the aforementioned timeline is provided for the purposes of initial planning and preparation of bids of potential auditors, as well as indicative planning of resources in banks.

The CBCG reserves all rights to adjust the timeline during the process of AQR Manual preparation, as well as during the implementation of the AQR in accordance with the circumstances in the field and environment (including those relating to COVID-19 situation, possible introduction of a state of emergency, etc.).

Each bidder shall appropriately present the team with which it plans to perform the asset quality review. It should specify the number of people involved in this engagement, how many of them are highly qualified, and what experience the team members have in working on similar projects. It is necessary to provide information on qualifications and expertise (CV) of each team member,



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including evidence of meeting the minimum technical criteria, and of specific tasks that they will be performing. Each bidder shall present its activities and capabilities. The presentation shall include at least the description of the company's structure, types of executed activities, and specify similar projects that the company has carried out over the past three years, counting from the date of filing of the bid.

The AQR auditor shall ensure the collateral valuation quality assurance by the appraiser.

Item 2.

Auditor eligibility

Only eligible auditors may submit bids to banks.

Eligible auditors shall, as a minimum, meet the following:

- conditions for the independence of the AQR auditor;
- conditions for qualifications and operating capacity of the AQR auditor;
- conditions regarding the qualifications of the project manager;
- other general conditions and limitations.

In the event that it becomes known after the AQR auditors have been selected, or during the implementation of the AQR, that certain conditions were not met at the time of bidding or were violated in the meantime, the CBCG will be notified in writing by the bank and/or selected AQR auditor.

Conditions regarding the independence of the AQR auditor

With a view to providing the independence of the appraisal, AQR auditors shall meet at least the following conditions:

- At the moment the proposal to carry out the AQR is being submitted, all potential auditors shall be independent from any member of the board of directors, chief executive director and other executive directors of the bank, or any senior manager of the bank that is the subject of asset quality review. Independence, in particular, implies that the senior partner, partner, other partners (including directors) and/or employees that are to take part in the implementation of the AQR, do not perform¹ managerial functions in the bank, do not maintain personal, financial or close business relationships with the bank and its shareholders, and do

¹ Currently or in the past two years.



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not have any conflict of interest that might prevent the auditors from conducting the AQR in the bank.

- They shall not be connected persons to the bank in accordance with the applicable Banking Law.
- They shall not be hired in respect of banks for which they have audited financial statements for 2019, or for which they were hired to audit financial statements for 2020. Limitations also relate to persons connected with the AQR auditor, i.e. other members of the business group/network it belongs to.
- They shall not be hired in respect of banks for which they were selected to provide consulting and/or other professional services regarding the preparation for and carrying out the AQR. Limitations also relate to persons connected with the AQR auditor, i.e. other members of the business group/network it belongs to.
- They shall not be hired in respect of banks for which they have provided consulting and/or other professional services in 2019 and 2020, or for which they intend to provide services in 2020, where those services relate to the areas that are the subject of examination in the course of AQR. Limitations also relate to persons connected with the AQR auditor, i.e. other members of the business group/network it belongs to.

For the purpose of obtaining prior approval, the bank shall notify the CBCG of any professional services that the proposed AQR auditor has provided or has been providing over the past two years², in a manner and form as specified in Annex 1 of these Guidelines.

Fulfilment of the conditions regarding the independence shall be evidenced by an appropriate confirmation/official documents or notarised statement of bidder's authorised persons.

Minimum conditions regarding qualifications and operating capacity of the AQR auditor

Potential auditors eligible for selection and implementation of the AQR should be qualified to perform audit of financial statements of banks having their licenses and head offices in Montenegro (in accordance with the CBCG requirements), or in the European Union, or any of the Western Balkan countries (Serbia, Montenegro, Bosnia and Herzegovina, North Macedonia, Kosovo, and Albania).

² It means 2019 and 2020 and the respective part of 2018 observed until the day of submitting the notification to the CBCG.



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Potential auditors shall meet the following conditions:

- Minimum 30% of the team that will be engaged in the project shall comprise experts with the experience of participating in at least one project relating to the AQR and/or diagnostic studies of banks in the past eight years, counting from the date of filing of the bid. Fulfilment of the criteria shall be evidenced by a confirmation by a competent supervisor or financial institution to which the services were provided or a notarised statement of authorised persons.
- Experts comprising the team shall have at least two years of relevant work experience (e.g. experience in providing consulting services or audit and connected services in the banking sector or experience with the AQR). Fulfilment of the criteria shall be evidenced by job resumes with signed statements by team members and the authorised person.
- Potential auditor's team should have one person responsible for the assurance of the quality of collateral valuation performed by AQR appraisers, and this person shall possess at least the following qualifications:
 - at least five years of experience in valuations;
 - experience of participating in at least two AQRs (or diagnostic studies of banks and similar engagements) in the European Union or any of the Western Balkan countries;
 - internationally recognised valuer certificate: Recognised European Valuer REV (TEGoVA) or MRICS RV (Member of Royal Institution of Chartered Surveyors, Registered Valuer).

Potential auditor shall provide sufficient capacities to perform all work tasks within the defined deadlines and at a satisfactory level.

Regarding the activities that the team leader or individual team members have performed so far, the CBCG made no objections that would result in the imposition of any penalties, legal or disciplinary proceedings or the initiation thereof before the competent authorities, as a consequence of any previous malpractice.

Minimum conditions regarding the project manager

The AQR auditor must ensure that the entire engagement is managed by at least two managers (General Manager and Operational Manager) of the expert team or teams, in the manner that will successful implementation of the process.



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The General Manager shall sign and approve all reports regarding the operation together with the Operational Manager.

The General Manager should meet the following conditions:

- possess adequate academic education;
- currently perform activities as a “partner/director/principal” or any of their equivalents within the entity in question;
- possess experience of participating in at least two AQRs in the European Union, in a managerial position in the past 8 years (counting from the date of filing of the bid);
- Regarding the activities that the General Manager has performed so far, the CBCG made no objections that would result in the imposition of any penalties, legal or disciplinary proceedings or the initiation thereof before the competent authorities, as a consequence of any previous malpractice.

The Operational Manager should meet the following conditions:

- possess adequate academic education;
- currently perform activities as a “partner/director/principal” or any of their equivalent within the entity in question;
- possess experience of participating in at least two AQRs or diagnostic studies of banks and similar engagements in the European Union or any of the Western Balkan countries in the past eight years (counting from the date of filing of the bid);
- Regarding the activities that the Operational Manager has performed so far, the CBCG made no objections that would result in the imposition of any penalties, legal or disciplinary proceedings or the initiation thereof before the competent authorities, as a consequence of any previous malpractice.
- be employed on a permanent basis (with the bidder or the office network of the company to which the potential auditor belongs).

Fulfilment of the criteria regarding the relevant AQR experience shall be evidenced by a confirmation by a competent supervisor or financial institution to which the services were provided, or by a notarised statement of authorised persons.

Other general conditions and limitations

The following eligible subjects may be selected as AQR auditors of a bank:



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- The bidder has duly performed all obligations based on taxes and contributions in accordance with the law, i.e. the regulations of the country in which it has its registered office (it is evidenced by submitting proof issued by the tax authority that all obligations based on taxes and contributions have been duly reported, calculated and executed, in accordance with the regulations of Montenegro, i.e. the regulations of the country where the bidder has its registered office).
- The bidder shall prove that they or their legal representative have not been convicted of any of the criminal offenses of organized crime with elements of corruption, money laundering and fraud (it is proved by submitting evidence of the competent authority issued on the basis of criminal records, which shall not be older than six months until the day of filing of the bid).
- Eligible entities are not in a conflict of interest with the bank, according to the internal rules of the bank or AQR auditor.
- The independence of the AQR auditor is not impaired or may be impaired due to other engagements / relationships he has with the bank.

Information that potential auditors must provide as proof of capability

For the purposes of selection, potential auditors should also provide the following as proof of capability:

- Details of the composition and number of members of the proposed team (specifying relevant experiences) along with job resumes (i.e. CVs) and certificates/licenses of key staff members who will be responsible for the tasks assigned throughout the project;
- Detailed project plan on how the potential auditor proposes that the project be carried out as defined in the AQR Manual (i.e. the ECB version for the purpose of making a bid; with the expected local adjustments);
- Details of how the potential auditor will ensure that the timeline is complied with and that the quality assurance process is established;
- Proposed fees (based on the expected number of expert hours required for the AQR);
- A description of how the potential auditor will ensure the confidentiality of data and results.



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Item 3.

Results expected from the AQR auditor and quality assurance by the CBCG

All outputs are expected to be delivered timely and adequately, in accordance with the AQR Manual or CBCG instructions submitted during the AQR.

It is expected that the outputs will be of adequate quality and that the possibility of verification will be provided.

The CBCG, together with its consultants, will establish a special system for quality assurance of the work of AQR auditors.

Item 4.

Information confidentiality

All issues related to the auditor's activities in the implementation of the AQR, including this terms of reference as well as any information or documents provided by the bank and/or the CBCG to the auditors, shall be considered confidential.

Banks and AQR auditors are required to provide conditions and measures to ensure the confidentiality of information, including appropriate contractual rights and obligations to all parties involved in the AQR process.

Item 5.

COVID-19 and business continuity plan

When drafting bids, the AQR auditors are encouraged to present their internal procedures, capacities and ability to operate smoothly in situations of stress, as well as anticipated risks, which may arise in particular from a pandemic declared by the World Health Organization, caused by the outbreak of COVID-19.

The CBCG believes that although these are not mandatory requirements for AQR auditors, the banks should consider these characteristics in the selection process, with a view to ensuring the highest possible level of business continuity in the given circumstances, i.e. the implementation of the AQR in a defined manner and within the defined deadlines.



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Annex 1 – Minimum information the Bank shall deliver regarding the previous and current engagements of the AQR auditor

| No. | Auditor (and all other parties involved) | Engagement | Description of the activity | Type of engagement (e.g. audit, consulting, appraisal, etc.) | Commencement of the engagement (dd/mm/yyyy) | End of the engagement (dd/mm/yyyy) | Contact person at the bank |
|-----|--|------------|-----------------------------|--|---|------------------------------------|----------------------------|
| 1. | | | | | | | |
| 2. | | | | | | | |
| ... | | | | | | | |