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June 21, 2021

Ms. Anna Mendiola
CEO/President
Federated States of Micronesia Development Bank

Dear Ms. Mendiola:

In planning and performing our audits of the financial statements of Federated States of Micronesia Development Bank (the Bank) as of and for the year ended December 31, 2020 (on which we have issued our report dated June 21, 2021), in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, we considered the Bank's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Bank's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses or significant deficiencies. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to the Bank's internal control over financial reporting and other matters as of that we wish to bring to your attention.

We have also issued a separate report to the Board of Directors, also dated June 21, 2021, on our consideration of the Bank's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.

The definition of a deficiency is also set forth in the attached Appendix I.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with this report.

This report is intended solely for the information and use of management, the Board of Directors, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of the Bank for their cooperation and assistance during the course of this engagement.

Very truly yours,

Deloitte & Touche LLP

APPENDIX I

SECTION I – DEFICIENCIES

We identified the following deficiencies involving the Bank's internal control over financial reporting for the year ended December 31, 2020 that we wish to bring to your attention:

1. <u>Credit Administration</u>

   <u>Condition</u>: The following exceptions were noted in the respective credit files:

   a) Loan # D3D-7143, D3F-7149, D4E4596B1, D4E6351LM, D4E6710L3 and D5E5103LK: Credit life insurance policy was not on file.

   b) Loan # D3D-5842A, D3D-7048 and D3R-6527: Hazard insurance policy was not on file.

   c) Loan # D3D-6974, D3D-7143, D3D-5842A, D4E-5631A, D4E-6142, D4E4596B1, D4E6351LM, D4E6710L3, D5F-6753, D3E-6356 and D5E5103LK: Updated financial information from the borrower was not on file.

   <u>Recommendation</u>: Completeness of credit files should be subject to verification. The Bank should review Loan File Checklists and follow up on open items timely.

   <u>Auditee's Response</u>:

   a) We agree with this finding and recommendation.
   b) We agree with this finding and recommendation.
   c) We agree with this finding and recommendation.

SECTION II – OTHER MATTERS

We identified, and have included below, another involving the Bank's internal control over financial reporting as of December 31, 2020, that we wish to bring to your attention:

1. <u>Loan Risk Grading Differences</u>

   <u>Condition</u>: We recommended the following loan classification changes:

Loan number	12/31/2020 Balance	Bank	Audit
D4P-7152	$ 3,493	4	6
D5E5103LK	$ 187,103	1 & 2	5
D3C-5377	$ 266,662	5	6

   We noted a variance in the allowance for loan losses per Bank's schedule and General Ledger. The variance is due to an unreconciled variance per the Bank's schedule and an additional provision from the classification changes which are documented above. The proposed audit adjustments were reviewed and accepted by the Bank during the course of the audit and were passed as uncorrected misstatement as of December 31, 2020.

   <u>Recommendation</u>: The Bank should review the loan classification report based on past due dates, with consideration of payment history, probability of collection from borrowers and length of time since the last loan restructure.

SECTION II – OTHER MATTERS, CONTINUED

1. Loan Risk Grading Differences, Continued

   Auditee's Response: We agree with the recommendation and loan classification changes, however, we do have some comments. For Loan #D535103, the classification of I & 2 was an oversight on our part in the listing on the report. This account has always been classified as a 5. For Loan #D3C -5377 , we would like the auditor to note that we classified this loan as a 5, not 6, due to the values of the securities pledged for this particular loan being significantly strong. ln addition, though it is not documented and the loan was not part of our deferral program, we did consider that the client communicated to us that it was experiencing some difficulty servicing the loan due to the loss of current and potential customers caused by the pandemic.

SECTION III – DEFINITIONS

The definition of a deficiency is as follows:

A *deficiency* in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

Management's Responsibility

The Bank's management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

Inherent Limitations of Internal Control over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.