NRC000132

Risk Management Manual of Examination Policies

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Section 1.1 - Basic Examination Concepts and Guidelines

Rationale of Bank Examinations

What are the purposes of bank examinations? Although many answers to this question could be given, several fundamental reasons can be identified.

The first relates to the maintenance of public confidence in the integrity of the banking system and in individual banks. Such confidence is clearly essential because the system's customers serve as the source of funding, without which banks would be unable to meet their most fundamental objective of providing financial services. The existence of unhealthy or deteriorating conditions, which may threaten this integrity, should be disclosed through the examiner's evaluation of the bank's capital adequacy, asset quality, management, liquidity position, earnings capacity, and sensitivity to market risk.

Second, the periodic on premise examination provides the best means of determining the bank's adherence to laws and regulations. Compliance with statutory and regulatory requirements has traditionally been given high priority by bank supervisors, and Congress has frequently reaffirmed this posture.

A third response to the question concerns the role examinations play in protecting the financial integrity of the deposit insurance fund. That is, the examination process can help prevent problem situations from remaining uncorrected and deteriorating to the point where costly financial assistance by the FDIC, or even a payoff of depositors, becomes unavoidable.

Finally, the examination supplies the supervisor with an understanding of the nature, relative seriousness and ultimate cause of a bank's problems, and thus provides a factual foundation to soundly base corrective measures, recommendations and instructions. The examination thus plays a very key role in the supervisory process.

Conduct of Examinations

The examination function lies at the heart of the FDIC's ability to maintain public confidence in the integrity of the banking system and in individual insured institutions. Given the fundamental reasons for conducting a bank examination, access to all records and employees of the bank must be made available to the supervisory staff during an examination.

Sections 10 (b) and (c) of the FDI Act empower examiners to make a thorough examination of the bank's affairs. The examiner should contact the Regional Office for guidance when faced with serious impediments to the examination, including uncooperative executive officers, or restricted access to bank employees or records. The Regional Office will determine an appropriate solution to enable examiners to obtain the information needed to complete the examination. In such cases, the examiner should document the significant examination obstacles and the Regional Office's resolution of the situation.

Prohibition Against Political Communication

FDIC employees should avoid any form of political communication with insured depository institutions that could be perceived as suggesting that the examination process is in any way influenced by political issues or considerations, or that the bank should take a particular position on political or legislative issues. The integrity and effectiveness of the examination process depends upon its being kept completely free from any appearance of being influenced by political considerations. Contacts that occur with insured depository institutions through the examination process concerning legislative or political issues run the risk of being misperceived as implying that a bank should take a particular position on such issues. FDIC employees should inform their Regional Office of any situations in which they feel the above policy might be compromised.

The Uniform Financial Institutions Rating System

and composite ratings with senior management, and when appropriate the board of directors, within as close proximity to the conclusion of the examination as possible. Examiners should clearly explain that the ratings are tentative and subject to final approval by the Regional Director.

Examiners should discuss the factors they considered when assigning the component and composite ratings. Examiners should also indicate that the composite rating is not based on a numerical average, but rather that it is based on a qualitative evaluation of an institution's overall managerial, operational, and financial performance.

The rating of the management component will be particularly sensitive and important. The quality of management is often the single most important element in the successful operation of an insured institution, and is usually the factor that is most indicative of how well risk is identified, measured, monitored, and controlled. For this reason, examiners should thoroughly review and explain the factors considered when assigning the management rating. Written comments in support of the management rating should include an assessment of the effectiveness of existing policies and procedures in identifying, monitoring, and managing risk.

Finally, management should be reminded that the composite and component ratings, whether disclosed verbally or in the written report of examination, are subject to the confidentiality rules imposed by Part 309 of the FDIC's Rules and Regulations.

Examination Frequency

The Division of Supervision and Consumer Protection’s (DSC’s) first priority is the effective surveillance and supervision of banks requiring special supervisory attention. The examination process best accomplishes identification of those banks. Section 337.12 of the FDIC Rules and Regulations which implements Section 10(d) of the FDI Act, requires an annual full-scope on-site examination of every insured state nonmember bank at least once during each 12-month period. Annual examination intervals may be extended to 18 months under the following conditions:

- The bank has total assets of $250 million or less;
- The bank is Well capitalized as defined in Section 325.103 of the FDIC Rules and Regulations;
- At the most recent FDIC or applicable State banking agency examination, the FDIC found the bank to be well-managed;
- At the most recent FDIC or applicable State banking agency examination, the FDIC assigned the insured state nonmember bank a composite rating or 1 or 2 under the UFIRS;
- The bank currently is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System; and
- No person acquired control of the bank during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the above noted exceptions.

DSC strives to provide safety and soundness and specialty examinations of all state nonmember banks within prescribed intervals. If examination frequency requirements, other than a few nominal and non-recurring exceptions, can not be met, a memorandum should be prepared and submitted to the Director of DSC. The memorandum should include a description of the nature and cause of the situation and a description of any needed, planned, or implemented corrective measures designed to maintain an adequate supervision program.

Alternate Examinations

Examinations may be conducted in alternate 12 (or 18) month periods if the FDIC determines that a full-scope, on-site examination completed by the appropriate State supervisory authority during the interim period is acceptable. However, such alternate examinations should be accepted only for the following institutions: composite 1- or 2-rated institutions; and for stable and improving composite 3-rated institutions if the composite rating is confirmed by the Statistical Camels Offsite Review (SCOR) review program and no adverse trends are noted from other available information. The length of time between the end of one examination and the start of the next (whether one or both of the examinations are conducted by a State supervisory agency or the FDIC) should not exceed 12 (or 18) months.

For purposes of monitoring compliance with examination frequency schedules, the end of the examination is defined as the earlier of the date the report is submitted for review or 60 calendar days from the *Examination Start Date* as defined in the Report of Examination Instructions.

Specialty Examination Intervals

The statutory requirements in section 10 (d) of the FDI Act do not apply to specialty examinations. Thus, specialty examinations are governed by internal DSC policy, not statute. Specialty examinations should generally be conducted concurrently with safety and soundness examinations, except when the size or arrangement of the department makes it impractical or inefficient to do so. Although there will be some differences, specialty examinations (including IT, trust, registered transfer agent, government securities brokers/dealers, municipal securities broker/dealers, and Bank Secrecy Act (BSA) are generally subject to the same examination intervals, including appropriate extensions, as safety and soundness examinations.

Regional Directors can make reasonable adjustments to specialty examination intervals to accommodate concurrent examinations where rating differences or alternate State examinations result in examination intervals that are not conducive to scheduling concurrent examinations. Reasonable adjustments include extending the examination cycle for 1- and 2-rated specialty areas. Although not permitted by statute for safety and soundness examinations, internal policy allows Regional Directors to also extend the examination cycle for 3-rated specialty areas. Specialty areas rated 4 or 5 should normally not be extended beyond a one-year interval. Additionally, since Municipal Securities Dealers are subject to a two-year examination cycle under Municipal Securities Rulemaking Board rules, any adjustment in this area should not exceed the two-year requirement. The possibility of conducting specialty examinations with State authorities should be explored if reasonable adjustments can be made.

When the State supervisory authority has examination responsibility for the safety and soundness examination of an institution, it will **not** be the responsibility of the region to conduct any specialty examinations that are not conducted by the State supervisory authority, with the exception of BSA examinations. If safety and soundness examinations are conducted under the alternating examination cycle program, and the State does not conduct a BSA examination, then the FDIC is required to conduct a BSA examination. Refer to internal DSC policy for additional information.

Insured Branches of Foreign Banks

Insured branches of foreign banks are required to be examined every 12 months under Section 10(d) of the FDI Act. However, Section 347.214 of the FDIC Rules and Regulations specifies that domestic branches of foreign banks may be considered for an 18-month examination cycle when certain criteria are met, and no other factors would suggest more frequent examination. To be eligible for an extended 18-month examination cycle, a US branch or agency of a foreign bank must:

- Have total assets of $250 million or less;
- Have a composite ROCA supervisory rating of 1 or 2 at its most recent examination;
- Meet one of the designated Well capitalized criteria;
- Not be subject to a formal enforcement action; and
- Not have undergone a change in control during the preceding 12-month period.

Additional factors may also be considered in determining examination frequency, including certain discretionary standards outlined in Section 347.214(b)(2).

Examination Types

Risk Focused Supervision

Effective risk management has always been central to safe and sound banking activities and has become more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of the bank, including the assessment of risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing resources on the bank's highest risks. The exercise of examiner judgment to determine the depth of review in each functional area is crucial to the success of the risk-focused supervisory process.

The most effective and efficient examination approach focuses examiner resources on validating bank management's ability to identify, measure, monitor, and control risks. Internal audits, external audits, loan review, and other control activities are integral to a bank's own assessment of its risk profile. Refer to the Internal Routine and Controls section of this Manual for an in depth discussion of this area.

Examiners should consider the adequacy of these functions in determining the risk profile of the bank and the opportunities to reduce regulatory burden by testing rather than duplicating the work of these audit and control functions. Transaction testing remains a reliable and essential examination technique for use in the assessment of a bank's condition. The amount of transaction testing necessary to evaluate particular activities generally depends on the quality of the bank's process to identify, measure, monitor, and control the risks in the banking activity. Once the integrity of the management system is verified through testing, conclusions on the extent of risks within the activity can be based on the internal management system rather than on evaluating the potential risk to the bank.