



# Office of Inspector General

March 29, 2004  
Report No. 04-015

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**Division of Supervision and Consumer Protection's  
Supervisory Appeals Process**

## AUDIT REPORT



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**DATE:** March 29, 2004

**MEMORANDUM TO:** Michael J. Zamorski, Director  
Division of Supervision and Consumer Protection

**FROM:** *for* Russell A. Rau  
Assistant Inspector General for Audits

**SUBJECT:** *Division of Supervision and Consumer Protection's Supervisory Appeals Process*  
(Report No. 04-015)

This report presents the results of our audit of the Federal Deposit Insurance Corporation (FDIC) Division of Supervision and Consumer Protection's (DSC) process for reviewing safety and soundness ratings questioned and appealed by FDIC-supervised institutions. We determined that this audit was warranted in the course of reviewing an allegation associated with the appeals process for material supervisory determinations.<sup>1</sup>

The overall objective of the audit initially was to determine whether the DSC followed appropriate procedures in upgrading a preliminary examination component rating<sup>2</sup> of an institution (the Bank) and in processing the Bank's appeal of its final safety and soundness examination ratings. The Bank initiated an appeal of material supervisory determinations related to three component ratings and the overall composite examination rating.<sup>3</sup> We subsequently expanded our audit scope to include determining whether the controls in the supervisory appeals process were adequate. Appendix I of this report discusses our audit objective, scope, and methodology in detail.

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<sup>1</sup> According to the FDIC's *Guidelines for Appeals of Material Supervisory Determinations*, dated March 21, 1995, a material supervisory determination generally includes:

- examination ratings,
- determinations relating to the adequacy of loan loss reserve provisions,
- classifications of loans and other assets in dispute,
- determinations relating to violations of a statute or regulation, and
- any other supervisory determination that may affect the nature and level of supervisory oversight or impact the capital, earnings, operating flexibility, or capital category for prompt corrective action purposes.

<sup>2</sup> Under the Uniform Financial Institutions Rating System, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components (see footnote 3) of an institution's financial condition and operations.

<sup>3</sup> The DSC *Manual of Examination Policies* defines a composite examination rating as an overall rating given to a bank based on the six components of the CAMELS rating system. The six components identified by the CAMELS acronym are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. A rating of 1 through 5 is given, with 1 having the least regulatory concern and 5 having the greatest concern.

## BACKGROUND

The DSC *Manual of Examination Policies* (Examination Manual) encourages contact and discussions with Bank management throughout the examination process. In addition, examiners-in-charge (EIC) are required to discuss preliminary examination ratings with senior management and, when appropriate, with the board of directors as close as possible to the conclusion of the examination. Moreover, the EIC is required to clearly explain that the ratings are subject to final approval by the Regional Director, who has the authority to make changes to preliminary examination ratings.

On March 21, 1995, the FDIC Board of Directors adopted the *Guidelines for Appeals of Material Supervisory Determinations*<sup>4</sup> (hereafter referred to as *Guidelines for Appeals*) to establish an independent intra-agency appellate process for the review of material supervisory determinations, as required by the Riegle Community Development and Regulatory Improvement Act of 1994.<sup>5</sup> In establishing the appeals process, the FDIC must ensure that: (1) any appeal of a material supervisory determination by an insured depository institution is heard and decided expeditiously and (2) appropriate safeguards exist for protecting the appellant from retaliation by agency examiners.

Under the *Guidelines for Appeals*, institutions may appeal material supervisory determinations within 60 days following receipt of the Report of Examination (ROE), provided the institution's board of directors has considered the merits of the appeal and has authorized its filing. An institution may appeal any material supervisory determination, which includes appealing CAMELS ratings.

If an institution is unable to resolve the dispute with the on-site examiner or regional office, the institution may file an appeal with the Director, DSC, in Washington. Under the *Guidelines for Appeals*, if the material supervisory determination under appeal is the joint product of the FDIC and a State regulatory authority, the DSC Director will promptly notify the appropriate State authority of the appeal, provide copies of relevant documents, and solicit that authority's views regarding the merits of the appeal before a final decision is made. Once the appeal has been filed, the regional office has 10 working days to review the institution's appeal and submit its comments and recommendations on the appeal to the Director, DSC. The Regional Director may approve the appeal if the Director finds in favor of an institution; if the appeal is not approved, a Washington DSC review panel is convened to review the case and prepare a recommendation for the Director, DSC. The Director, DSC, may approve any recommendation that finds in favor of an institution; however, if the Director is unable to resolve the appeal in favor of the institution,

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<sup>4</sup> The FDIC advised the financial institutions it regulates of the *Guidelines for Appeals* through Financial Institution Letter 28-95, *Guidelines for Appealing Supervisory Determinations*, dated April 4, 1995.

<sup>5</sup> The Act defines the term "independent appellate process" as a review by an agency official who does not directly or indirectly report to the agency official who made the material supervisory determination under review. The *Guidelines for Appeals* were intended to clarify the types of determinations that are eligible for review and to establish a process by which appeals would be considered and decided.

the appeal will be forwarded to a Supervisory Appeals Review Committee (SARC) for final consideration.<sup>6</sup>

According to a DSC management report entitled *Appeals of Material Supervisory Determinations*, dated December 2, 2003, 64 appeals had been filed with the FDIC in the past 9 years. The 64 appeals were related to: CAMELS composite and component ratings; Community Reinvestment Act<sup>7</sup> and Compliance examination ratings;<sup>8</sup> apparent regulatory violations; classified assets; loan allowances; information system and trust examination results; termination of a cease and desist (C&D) order;<sup>9</sup> restatements of Call Report<sup>10</sup> items; subprime designations of credit card portfolios; accounting treatment of accrued interest receivables; and designations of problem bank status.

The 64 appeals noted above were filed by 54 FDIC-supervised institutions. Of the 64 appeals filed, 40 related to safety and soundness issues. Of these 40 appeals, 2 appeals are currently in process. For the remaining 38 appeals:

- 6 were fully or partially approved by the Director, DSC;
- 4 were withdrawn by the institution;
- 4 were fully or partially approved by the SARC; and
- 24 were denied by the SARC.

## RESULTS OF AUDIT

The DSC Regional Office complied with procedures related to upgrading a preliminary examination component rating. Consistent with those procedures, FDIC and State examiners held discussions with Bank management regarding its concerns with the preliminary ratings

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<sup>6</sup> The SARC consists of the Vice Chairperson; Director, DSC; Director, Division of Insurance and Research; Ombudsman; and General Counsel (or their designees). On March 10, 2004, the FDIC Board of Directors approved for publication in the Federal Register a Notice and Opportunity for Comment on proposed revisions to the Guidelines for Appeals that would change the composition of and the procedures governing the SARC and redefine the role of the Ombudsman in SARC appeals.

<sup>7</sup> The Community Reinvestment Act (CRA) was enacted as Title VII of the Housing and Community Development Act of 1977 and applies to all regulated federally insured financial institutions, excluding credit unions. The FDIC is responsible for evaluating the CRA activities of insured, state-chartered, nonmember financial institutions. CRA evaluations are used by the FDIC and the public to assess how a bank meets the lending, investment, and service needs of the community it serves.

<sup>8</sup> Congress, by statute, has assigned the FDIC enforcement responsibilities for various consumer protection, fair lending, and certain other regulations for financial institutions supervised by the FDIC. The Compliance examination is the primary means by which the FDIC determines the extent to which a financial institution is meeting its responsibility to comply with the requirements and prescriptions of the various laws and regulations.

<sup>9</sup> A formal enforcement action issued by FDIC's Board of Directors to a bank or affiliated party to stop an unsafe or unsound practice or violation. A C&D may be terminated when the bank's condition has significantly improved and the action is no longer needed or the bank has materially complied with its terms.

<sup>10</sup> Call Reports are sworn statements of financial condition that financial institutions submit to the FDIC quarterly in accordance with federal regulatory requirements in 12 Code of Federal Regulation. The reports consist of a balance sheet, income statement, and other supplemental information and provide detailed analyses of balances and related activity.

during the course of the examination. In addition, the Regional Director acted within delegated authority when changing the preliminary component rating.

With respect to the Bank's formal appeal of the final examination ratings:

- The current procedures do not require an independent DSC analysis of examination information relevant to an appeals case when critical examination findings are not fully supported. Consequently, the FDIC risks making an appeals decision based on incomplete information or less than a full understanding of the circumstances of the determination under appeal.
- DSC did not fully coordinate with the State regulatory authority throughout the appeals process, even though the examination was conducted jointly. As a result, the FDIC could not ensure that the State's views had been fully documented and considered in the appeals process.
- Both the DSC regional and Washington offices considered information on institution actions implemented after the timeframe covered by the examination, which is contrary to FDIC policy.

We are recommending that DSC enhance and enforce current appeals procedures for material supervisory determinations to help ensure that the FDIC appeals process is administered in a fair, efficient, and effective manner and that fully informed decisions are made that are reflective of the merits of the case at the time of the supervisory determination.

## **SUPERVISORY APPEALS PROCEDURES COULD BE IMPROVED**

DSC staff reviewing the Bank's appeal did not obtain and analyze additional information that may have been relevant in determining the merit of the Bank's appeal. Current policy requires a review of a case for consistency with FDIC policies, but does not require the collection and analysis of additional information such as examination workpapers that may be relevant to reviewing appeals. Although additional supporting information may not always be required to substantiate a rating upgrade, without independent analyses DSC risks making decisions on appeals based on incomplete information or a less than full understanding of the circumstances surrounding supervisory determinations being appealed.

The DSC *Compliance Examination Manual* Part V: Other Examination Policies and Procedures - Appeals Process (dated July 31, 1999) states that the appeal will be reviewed for consistency with the policies, practices, and mission of the FDIC, the Division of Supervision or the Division of Compliance and Consumer Affairs,<sup>11</sup> and for overall reasonableness and support of the respective positions advanced, but no other detailed guidance is provided. Further, current policies for the appeals process are outdated in that they do not reflect the current DSC organization.

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<sup>11</sup> Effective July 1, 2002, these two divisions were merged to form the new DSC.

During our review of the process for the Bank's appeal of its component ratings and overall composite rating, we found that the Washington office DSC review panel limited its analysis to the evidence provided in the regional office's appeal package, which included the 2002 ROE, the Bank's request for appeal, and the regional office recommendation to deny the appeal. Members of the review panel responsible for determining the merits of the case told us they did not request additional information or workpapers from the regional or field offices. Most importantly, the panel members did not conduct additional or independent analyses of the examination documentation to support their conclusions. In its memorandum recommending approval of the appeal, the review panel repeatedly noted that the 2002 ROE did not support the assigned ratings. However, the panel did not independently analyze the work performed by the EIC so that it could determine what the examination ratings should have been or whether they were appropriate. As a result of the review conducted by the review panel, the Bank's appeal was partially granted and the Bank's 2002 composite rating was upgraded.

According to discussions with DSC management in Washington, the EIC's primary criticism centered on one component of the Bank's capital. However, the Capital Markets Specialist on the review panel did not agree with the EIC's assessment of the potential risk involved in this area.

We reviewed the 2002 ROE workpapers to determine whether additional information to support the EIC's findings existed but had not been used by the review panel members. We focused our review on the workpapers for the three component ratings the Bank had appealed. In reviewing the workpapers, the allowance for loan and lease losses (ALLL),<sup>12</sup> and the 2002 ROE, we found information related to the calculation of the Bank's ALLL that would have provided the review panel a more comprehensive understanding of the Bank's deficiencies. Had the review panel analyzed the examination workpapers, it would have had a more sufficient basis on which to determine whether the examination ratings were appropriate.

As noted earlier, DSC review panel members concluded that the Bank's 2002 ROE did not substantiate the assigned ratings. If that was the case, an independent review of the supporting workpapers by the review panel should have been conducted to more accurately determine the condition of the Bank at the time of the examination and to make informed decisions regarding the Bank's ratings. Without the information that would be gained from such a review, the review panel risked lacking adequate justification for upgrading the Bank's composite rating, or conversely, denying the Bank's appeal -- had that been the panel's conclusion.

The objective of an examination is to help ensure a financial institution's safety and soundness and to minimize the degree of risk exposure presented to the banking system and deposit insurance fund. Enhancing the guidance that requires review panel members to obtain and independently review information supporting the supervisory determination being appealed (such as examination workpapers and the EIC's perspective) will help ensure that review panels make fully informed decisions on the merits of the case.

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<sup>12</sup> Federally insured depository institutions must maintain an ALLL at a level that is adequate to absorb the estimated credit losses associated with the loan and lease portfolio (including all binding commitments to lend). To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit.

## **Recommendation**

We recommend that the Director, DSC:

1. Establish DSC policy for reviewing appeals of material supervisory determinations to include guidance regarding the type and extent of documentation needed for conducting independent analyses of the merits of an appeals case. Such guidance should specify the circumstances under which examination workpapers should be obtained and discussions held with the EIC.

## **SUPERVISORY APPEALS PROCEDURES WERE NOT ALWAYS FOLLOWED**

### **Concurrence by the State Banking Authority**

DSC Washington staff could have more fully coordinated with the State regulatory authority regarding the decision to grant the Bank's appeal. For example, rather than contacting the State directly, the Washington office obtained oral comments from the regional office pertaining to the State's concurrence in granting the Bank's appeal. As a result, DSC did not have a complete record of the merits of the case and did not ensure that the State's position was fully documented and considered when DSC was preparing the final appeal recommendation.

The FDIC *Intra-Agency Appellate Process* (61 F.R. 7042, published March 28, 1995) specifically addresses coordination with State regulatory authorities as follows:

In the event that a material supervisory determination under appeal is the joint product of the FDIC and a State regulatory authority, the appropriate Division Director will promptly notify the appropriate State regulatory authority of the appeal, provide to the regulatory authority a copy of the institution's request for review and any other related materials, and solicit the regulatory authority's views regarding the merits of the appeal before making a final decision. That Director will present the views of the regulatory authority (as well as his or her own views) before the Supervisory Appeals Review Committee and attempt to reconcile the views of the regulatory authority with the views of the Supervisory Appeals Review Committee. The Supervisory Appeals Review Committee will notify the institution and the State regulatory authority of its decision, and any differences remaining between the institution and the State authority will be left to those parties to resolve.

This policy underscores the importance of obtaining the State regulatory authority's position on all appeals related to a joint product with FDIC and requires that when the State and the FDIC disagree, the case should be elevated to the SARC for reconciliation.

The Washington office review panel's recommendation for granting the appeal contains a section entitled Position of the Other Regulatory Agency, which notes that the State regulatory authority was contacted. The section specifically states that the regional office discussed the possibility of granting the appeal, or portions of the appeal, with the State and that the State indicated it would support any final Washington office material supervisory determinations. However, our review



of regional office correspondence identified a letter from the State Commissioner to the DSC Regional Director regarding the appeal of the joint examination findings. In this letter, the Commissioner stated that after careful review of the ROE and the Bank's response to the report, he believed that the report accurately reflected the condition of the Bank at the time of the examination and that the examination findings and assigned CAMELS ratings were appropriate.

The Director, DSC, notified the Bank in writing that DSC had granted the appeal of two component ratings and acknowledged the Bank's withdrawal of the appeal of the third component rating. The Bank was also informed that its overall composite rating would be upgraded. Although the State provided a written response supporting the regional office recommendation to deny the appeal, there was no written documentation from the State to support any subsequent concurrence with the Washington office decision to grant the appeal.

State officials stated they were not contacted by the DSC Washington staff regarding the appeal of the Bank's final examination ratings. Instead, the Regional Director called to inform State officials that the Washington office had overturned the ratings. Although the State did not agree with the results of the appeal, the State sent a letter to the Bank informing it that the State would accept the results of the FDIC's review of the Bank's appeal. During discussions with State officials, we were informed that the State's only alternative would have been to pull out of the examination and perform an independent examination. Also, the State did not contest the results of the appeal because the Bank's earnings had started to improve, and State officials believed they had accomplished what they wanted -- to prompt the Bank to initiate corrective actions. In addition, at the time the FDIC granted the appeal, the State had also planned to conduct a 6-month visitation to the Bank. However, the State was asked by the FDIC not to conduct the visitation at that time.

Without strict adherence to the procedures regarding coordination with State regulatory authorities, the FDIC cannot ensure the fairness, efficiency, and effectiveness of the appeals process. Also, lacking written documentation from the State regulatory authority regarding its position, DSC will not have a complete record of the merits of the case and would not be able to substantiate the State's views regarding an appeal.

## **Recommendation**

We recommend that the Director, DSC:

- (2) Reiterate, in written guidance that enforces the FDIC's *Intra-Agency Appellate Process*, the importance of coordinating and communicating with State regulatory authorities throughout the appeals process, and prior to making appeal decisions, obtain the written views of State regulatory authorities to have a complete record of the disposition of appeals.

## **Use of Subsequent Information**

While conducting its review of the appeal, the Washington office considered information on institution actions implemented after the examination which is contrary to FDIC policy. The

Bank had included the subsequent information in its materials presented to the review panel. As a result, information not available during the examination was used in preparing the appeal recommendations and in deciding the merits of the case.

According to the FDIC's *Intra-Agency Appellate Process*, the scope of the review for any material supervisory determination is limited to the facts and circumstances as they existed prior to or at the time the material supervisory determination was made. No consideration is to be given to any facts or circumstances that occur or corrective action taken after the determination was made. However, the FDIC will consider facts that may have been discovered by or come to the attention of the FDIC or the institution after the determination.

The FDIC's *Intra-Agency Appellate Process* does not provide sufficient guidance or procedures regarding the specific information to be submitted by a bank to support its request for an appeal. The policy states that to initiate an appeal, the institution must submit, in writing, to the Director of the Division of Supervision, a request for review and that:

The request for review should include: (a) a detailed description of the issues in dispute, the surrounding circumstances, the institution's position regarding the dispute and any arguments to support that position, . . . how resolution of the dispute would impact the institution and why such impact would be material, and the good faith effort to resolve the dispute with the on-site examiner and the Regional Office and the results of that effort; and (b) a statement that the institution's board of directors has considered the merits of the appeal and authorized that it be filed.

We found one instance where information provided after the examination "As of Date" was considered by the review panel members. In a letter to the regional office, the Bank acknowledged receipt of the final ROE and expressed its dissatisfaction with the examination ratings. In addition, the Bank included information on planned corrective actions, and on data related to a capital infusion. Although the capital infusion was made subsequent to the close of the examination, the DSC Washington office recommendation included this data as part of its support for upgrading a component rating. The Bank also provided future projections of income to support its appeal case, but this information was not included in the Washington office recommendation.

Making appeal decisions based on information or events subsequent to the examination timeframe is contrary to FDIC policy and could result in decisions that are not reflective of the merits of the case at the time of the examination. In addition, institutions could introduce or present information or arguments that were not available to the examination team and, as a result, were not factored into the EIC's assessment of the institution.

## **Recommendations**

We recommend that the Director, DSC:

- (3) Reiterate, in written guidance to DSC, the FDIC's *Intra-Agency Appellate Process* policy requiring that review of appeals be limited to the facts and conditions prior to or at the time the material supervisory determination is made.

- (4) Clarify, in written guidance to FDIC-regulated institutions, the FDIC's *Intra-Agency Appellate Process* requirement that information submitted in conjunction with appeals is to be limited to the facts and conditions prior to or at the time the material supervisory determination is made.

## **CORPORATION COMMENTS AND OIG EVALUATION**

On March 23, 2004, the DSC Director provided a written response to the draft report. The response is presented in Appendix II to this report. DSC generally concurred with the report's findings and agreed to take actions regarding the report's recommendations. In addition to responding to the recommendations, the Director provided comments on certain aspects of the report pertaining to our assertion that additional guidance is needed to ensure that information submitted in conjunction with appeals is limited to the facts and conditions prior to or at the time the material supervisory determination was made. DSC did not believe that post-examination information played a measurable role in the panel's assessment of the specific appeal reviewed by the OIG. The Director further stated that as a standard practice, DSC reviews only the facts and conditions prior to or at the time of the material supervisory determination. Nevertheless, the Director indicated that the proposed update of the guidance to examiners in this area, in the form of a Regional Directors Memorandum, will address each of the OIG's concerns and will be made available to institutions on the external FDIC Website.

DSC's response to the draft report meets the intent of the recommendations. Accordingly, the recommendations are resolved but will remain undispositioned and open until we have determined that agreed-to corrective action has been implemented and is effective.

On March 2, 2003, we provided the State Commissioner the draft report for review and comments. On March 26, the Commissioner's office responded that special consideration had been given to all areas of the report related to the joint examination experience and the State's participation with regional office personnel during the appeals process. The Commissioner's office had no objection to any of the comments in the report and was satisfied that it presented the facts of the situation. The Commissioner's office also noted that it appreciated the close working relationship it enjoyed with DSC's regional office during the difficult period of this examination and appeal.

## OBJECTIVE, SCOPE, AND METHODOLOGY

The overall objective of our audit was to determine whether the DSC followed appropriate procedures in upgrading the Bank's ratings and in processing the Bank's appeal. We subsequently expanded the scope to include determining whether the controls in the supervisory appeals process were adequate. The audit work was conducted from September 2003 through January 2004 in accordance with generally accepted government auditing standards.

To accomplish our objective we:

- reviewed policies, procedures, laws, and regulations related to rating upgrades and appeals of material supervisory determinations;
- reviewed DSC management and tracking reports for appeals;
- reviewed DSC headquarters, regional office files, and field office workpapers for the Bank's 2002 examination;
- interviewed DSC headquarters and regional office staff involved in the preliminary component rating upgrade and the Bank's supervisory appeal, the FDIC Ombudsman, and the FDIC Deputy to the Chairman; and
- visited the State financial regulatory authority's headquarters to interview the Commissioner and staff involved in the Bank's 2002 joint examination and to review their workpapers and supervisory files for the Bank.

We also reviewed FDIC criteria related to the processing of rating changes and appeals of material supervisory determinations, which can be found in various FDIC financial institution letters and Regional Director Memorandums, the *DSC Manual of Examination Policies*, *Compliance Examination Manual*, and the *Case Manager Procedures Manual*:

- Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 requires the FDIC (as well as the other federal banking agencies and the National Credit Union Administration Board) to establish an independent intra-agency appellate process to review material supervisory determinations.
- FDIC's *Intra-Agency Appellate Process* (61 F.R. 7042, published March 28, 1995) implements Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994, requiring the FDIC to implement an appellate process for review of material supervisory determinations. The policy includes the *Guidelines for Appeals of Material Supervisory Determinations*.
- Financial Institution Letter No. 28-95: *Guidelines for Appealing Supervisory Determinations* (dated April 4, 1995) provides banks with the guidance and requirements for filing appeals of material supervisory determinations.

- Regional Director Memorandum 95-056: *Procedures for Processing Appeals of Material Supervisory Determinations* (dated May 15, 1995) establishes policy and procedures for meeting the obligations under the FDIC's appeals process. The memorandum states that, "since it is difficult at this point to anticipate the nature and volume of appeals that might be filed and the timeframes involved at each stage of processing, the following are established as interim procedures for processing appeals filed in the Washington office with the Director of the Division of Supervision."
- *DSC Case Manager Procedures Manual*, Part I Section 7: Appeals, contains case managers' instructions for processing appeals. In addition, Part I Section 3.3: Problem Bank and Rating Change Memorandum, contains criteria for processing examination rating changes.
- *Filing Appeals with the FDIC* is a brochure prepared by the FDIC Office of Ombudsman. The brochure, updated February 1, 2002, describes the FDIC appeals process for material supervisory determinations and provides the steps, timeframes, and procedures associated with a formal appeal to the FDIC.

### **Government Performance and Results Act, Reliance on Computer-Generated Data, Fraud and Illegal Acts, and Management Controls**

The limited nature of the audit objective did not require reviewing related performance measures under the Government Performance and Results Act or determining the reliability of computer-processed data obtained from the FDIC's computerized systems. Not performing assessments of these areas did not affect the results of our audit. In addition to reviewing the allegation associated with the appeals process, our audit included steps for providing reasonable assurance of detecting fraud and illegal acts. Additionally, we gained an understanding of relevant control activities by examining DSC-applicable policies and procedures as presented in the *DSC Manual of Examination Policies* and Regional Director Memoranda. Our testing of internal controls was limited to reviews of compliance with applicable laws, regulation, policies, and procedures.

### **Pertinent Laws and Regulations**

Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 requires the FDIC (as well as the other Federal banking agencies and the National Credit Union Administration Board) to establish an independent intra-agency appellate process to review material supervisory determinations. Guidance on the FDIC's intra-agency appellate process was published on March 28, 1995. We did not find any instances in which the FDIC was not in compliance with pertinent laws and regulations.

## CORPORATION COMMENTS



Federal Deposit Insurance Corporation  
550 17th Street NW, Washington, D.C. 20429-9990

March 23, 2004

**TO:** Stephen M. Beard  
Deputy Assistant Inspector General for Audits  
Office of Inspector General

**FROM:** Michael J. Zamorski *Michael J. Zamorski*  
Director  
Division of Supervision and Consumer Protection

**SUBJECT:** Response to OIG Draft Report Entitled *Division of Supervision and Consumer Protection's Supervisory Appeals Process* (Assignment No. 2004-008)

The Division of Supervision and Consumer Protection (DSC) appreciates the opportunity to respond to the Office of Inspector General's (OIG) draft report dated March 19, 2004, entitled, "Division of Supervision and Consumer Protection's Supervisory Appeals Process" (Report). Overall, DSC agrees with the OIG's assessment that the supervisory appeals procedures could be enhanced. A review of DSC's existing supervisory appeals process has already been completed, and revised procedures were drafted and are currently being reviewed. Provided below are DSC's responses to the Report's recommendations.

*(1) Establish DSC policy for reviewing appeals of material supervisory determinations to include guidance regarding the type and extent of documentation needed for conducting independent analyses of the merits of an appeals case. Such guidance should specify the circumstances under which examination workpapers should be obtained and discussions held with the EIC.*

DSC Response:

DSC partially concurs with this recommendation. In 1995, DSC issued two Regional Director Memoranda that established supervisory appeal procedures. These procedures were also incorporated into DSC's Case Manager's Manual and Compliance Manual. These documents provide specific steps governing the timely receipt, acknowledgment, review, and resolution of supervisory appeals. DSC supervisory appeal procedures are augmented by applicable banking laws and regulations and extensive FDIC policies and procedures that provide detailed guidelines as to what factors should be considered when making (or assessing) a supervisory determination.

DSC staff has and will continue to obtain, through initial submissions or follow-up requests, sufficient information to make an informed assessment of an appeal. This could include review of workpapers or discussion with the examiner-in-charge. However, the

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determination to review workpapers or hold discussions with the examiner-in-charge will be made on a case-by-case basis when deemed necessary by the subject matter experts reviewing the appeal.

DSC Action:

DSC will update existing procedures to reflect current practices and will reemphasize DSC staff's responsibility to obtain sufficient information to make an informed assessment of an appeal. Updated procedures will be issued in the form of a Regional Director memorandum. DSC will also make these procedures available on the FDIC's external website. These items will be completed by December 31, 2004.

- (2) *Reiterate, in written guidance that enforces the FDIC's Intra-Agency Appellate Process, the importance of coordinating and communicating with State regulatory authorities throughout the appeals process, and prior to making appeal decisions, obtain the written views of State regulatory authorities to have a complete record of the disposition of appeals.*

DSC Response:

DSC concurs with this recommendation. DSC strongly believes in on-going communication with State regulatory authorities. DSC will update procedures to ensure that Regional and Washington Office staff properly document the State regulatory authority's view on the appeal.

DSC Action:

DSC's updated supervisory appeal procedures will include specific guidance on when the State regulatory authority should be contacted and how their view should be documented. Updated procedures will be issued in the form of a Regional Director memorandum. DSC will also make these procedures available on the FDIC's external website. These items will be completed by December 31, 2004.

- (3) *Reiterate, in written guidance to DSC, the FDIC's Intra-Agency Appellate Process policy requiring that review of appeals be limited to the facts and conditions prior to or at the time the material supervisory determination is made.*

DSC Response:

While DSC concurs with this recommendation, DSC does not believe post-examination information played a measurable role in the panel's assessment of the specific appeal reviewed by the OIG. A review of the panel's memorandum disclosed one instance where the panel's analysis of the capital component rating referred to information that occurred shortly after the signed Report of Examination was returned to the bank. However, the panel's decision was principally based on the facts and circumstances that existed prior to or

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at the time of the supervisory determination. Specifically, the panel's memorandum concludes,

"The findings of the ROE state that management, asset quality, and liquidity are satisfactory. The added risk and related capital needs attributed to the commercial loan growth or subprime loans are not well established or quantified and sensitivity to market risk (see comments below) is satisfactory. With the exception of Earnings that are low but improving, no other material or significant weaknesses have been established which warrant higher capital levels. Therefore, the Bank's capital level relative to its risk profile appears satisfactory and granting the appeal to upgrade the Capital rating to "2" from a "3" is recommended."

As a standard practice, DSC reviews only the facts and conditions prior to or at the time of the material supervisory determination. DSC will update its outstanding procedures to reiterate current practice as recommended.

DSC Action:

DSC's updated supervisory appeal procedures will emphasize the importance of limiting consideration to information that existed prior to or at the time of the supervisory determination. Updated procedures will be issued in the form of a Regional Director memorandum. DSC will also make these procedures available on the FDIC's external website. These items will be completed by December 31, 2004.

- (4) *Clarify, in written guidance to FDIC-regulated institutions, the FDIC's Intra-Agency Appellate Process requirement that information submitted in conjunction with appeals is to be limited to the facts and conditions prior to or at the time the material supervisory determination is made."*

DSC Response:

After reviewing current guidance, DSC believes no further clarification is needed to Section H of the March 21, 1995, Financial Institutions Letter, entitled, *Guidelines for Appealing Supervisory Determinations*, which clearly states the scope of the review of any material supervisory determination. Specifically, the scope is "limited to the facts and circumstances as they existed prior to or at the time the material supervisory determination was made and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made." Alternatively, we believe that our action under recommendation 3 to update and enhance our internal guidance and make these procedures available on the FDIC's external website will also serve to reinforce the current guidance to our FDIC-regulated institutions.



## MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management’s response to our report (and subsequent communication with management representatives.)

Rec. Number	Corrective Action: Taken Or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved: <sup>a</sup> Yes or No	Dispositioned: <sup>b</sup> Yes or No	Open or Closed <sup>c</sup>
1	DSC will update procedures to reflect current practices and reemphasize the need to obtain sufficient information to make an informed assessment of an appeal.	December 31, 2004	N/A	Yes	No	Open
2	DSC will update procedures related to contact with the State regulatory authorities.	December 31, 2004	N/A	Yes	No	Open
3	DSC will update procedures related to limiting use of information subsequent to the supervisory determination.	December 31, 2004	N/A	Yes	No	Open
4	DSC will clarify requirements to banks related to data submitted in appeals requests.	December 31, 2004	N/A	Yes	No	Open

<sup>a</sup> Resolved – (1) Management concurs with the recommendation and the planned corrective action is consistent with the recommendation.  
(2) Management does not concur with the recommendation but planned alternative action is acceptable to the OIG.  
(3) Management agrees to the OIG monetary benefits or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

<sup>b</sup> Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

<sup>c</sup> Once the OIG disposes the recommendation, it can then be closed.

**MANAGEMENT RESPONSE TO RECOMMENDATIONS**