

Department of the Treasury

## Regulatory Bulletin

# RB 37-1



Handbook: **Examination Handbook**

Subject: **Administration**

**Section: 010**

## Handbook and Program Use

**Summary:** This bulletin provides new Examination Handbook Section 010, Handbook and Program Use. This section replaces Thrift Activities Handbook (TAH) Sections 010, Handbook Use, and 011, Program Use, and Compliance Activities Handbook (CAH) Sections 100-1, Using the Compliance Handbook, and 100-2, Overview of the Specialized Compliance Program.

**For Further Information Contact:** Your Office of Thrift Supervision (OTS) Regional Office or the Thrift Policy Division of the OTS, Washington, DC. You may access this bulletin and the handbook section at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

### *Regulatory Bulletin 37-1*

#### SUMMARY OF CHANGES

OTS is issuing Examination Handbook Section 010, Handbook and Program Use. This is a new section that replaces various sections (see the Summary box above) of the Thrift Activities and Compliance Activities Handbooks so we did not include change bars. We provide a summary of substantive changes below.

#### **010 Handbook and Program Use**

Significant changes include:

- A discussion of the new Examination Handbook that accommodates a comprehensive safety and soundness and compliance examination process.
- A discussion of the revised Handbook Organization and the assignment of a new number 1000 for the Compliance chapter.
- Additional discussion of work papers from Section 060.
- A reference to the electronic work paper database in the EDS/ROE System.

—Scott M. Albinson

**Managing Director**

**Examinations, Supervision, and Consumer Protection**

## Handbook and Program Use

The Examination Handbook is a new Handbook that integrates safety and soundness (S&S) and compliance guidance. This new Handbook will eventually replace the Thrift Activities and Compliance Activities Handbooks. We will retain the general layout of the handbooks with a chapter for each CAMELS component and a chapter for Compliance and the Community Reinvestment Act (CRA). Until we complete the integration of S&S and compliance, you will also need to refer to the Thrift Activities and Compliance Activities Handbooks.

The Examination Handbook is a guide for the examination of savings associations regulated by the Office of Thrift Supervision (OTS). Specifically, the Handbook aids OTS regulatory staff and the savings and loan industry in the regulatory process. The Handbook provides uniform standards for planning and conducting examinations and addressing supervisory issues. It also serves as a reference tool, training aid, and guide to national policies and procedures.

The Handbook illustrates and describes, for examiners and the thrift industry, certain standards of conduct and prudent operation that OTS views as important to the safe and sound operation of savings associations. These standards should be consistent with the respective fiduciary duties of those individuals associated with them.

This Handbook Section explains how to use the Handbook and the programs in the examination process. It describes the organization of the Handbook chapters and sections, and sets forth objectives and procedures common to all phases of the examination.

### REGULATORY PROCESS

The regulatory process allows you to meet the following objectives:

- Assess an association's degree of safety and soundness.
- Assess the adequacy of the association's compliance management program.
- Assess how well an association manages compliance with consumer protection and public interest-related laws and regulations (Compliance).
- Evaluate an association's condition.
- Identify the association's strengths.

- Identify existing regulatory violations.
- Identify potential problems.
- Prevent the development or continuation of unsafe operating practices.
- Report findings.
- Inform directors of association strengths and weaknesses.
- Facilitate corrective action where needed.

Proactive regulatory supervision should evaluate future needs and potential risks to ensure the success of the thrift system in the long term. This Handbook provides a framework for the successful completion of that process.

The Handbook encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process.

The Handbook encourages independent reasoning, objectivity, efficiency, and professionalism in the examination process. To promote consistency among the OTS regional offices, the Handbook sets forth national minimum standards for examination objectives and procedures. While this process promotes standardization of the examination process, we encourage you to modify programs to fit the association's specific needs.

We are designing the Examination Handbook to cover S&S, compliance, and CRA for both new and experienced examiners. Background information, applicable references, and expanded procedures within the text serve to help in the learning process.

You should supplement your use of the Handbook and associated programs with your education, experience, and judgment. We will periodically update the Handbook and issue individual sections as necessary. Separate manuals are available for Compliance Self-Assessment, Holding Companies, Trust and Asset Management Activities, Information Technology (IT), and Applications Processing. These Handbooks are available via the OTS website.

## HANDBOOK ORGANIZATION

The Examination Handbook will contain a table of contents, one chapter for each CAMELS element, a chapter on other activities, and a chapter for Compliance and CRA. A brief discussion of the Handbook's organization appears below (currently reflected in the Thrift Activities and Compliance Activities Handbooks).

## Table of Contents

The table of contents lists each Handbook chapter, section number and title, and, if applicable, programs, questionnaires, and appendices.

### 000 Administration

This chapter gives a general overview of the administration and coordination of the regulatory process. It includes instructions on determining the scope of an examination, monitoring the regulatory profile process, assigning component and composite CAMELS ratings, and Compliance and CRA ratings, and devising an examination strategy.

### 100 Capital Adequacy

This chapter provides useful information for assessing whether an association's capital position is sufficient, given the risk level, to ensure ongoing viability. Discussions of minimum regulatory capital requirements, prompt corrective action (PCA) categories, and stock ownership and control help you determine the adequacy and composition of an association's capital.

### 200 Asset Quality

This chapter addresses the following two issues:

- The determination of risks related to the association's assets.
- The association's management, administration, and evaluation of the quality of these assets.

It also provides guidance in assessing credit risk and reviewing asset portfolios (including loans, investments, and other assets). This chapter focuses on three areas:

- The quality of loan underwriting and portfolio management.
- Affirmation of classified asset levels.
- Adequacy of valuation allowances.

There are also sections discussing real estate appraisals, loan sampling, the Qualified Thrift Lender Test, and margin securities.

### 300 Management

This chapter provides guidance in evaluating the capability of executive management and the board of directors. It covers objectives, procedures, and references for examining compliance management, internal controls, internal and independent audits, fraud and insider abuse, enforcement actions, and transactions with affiliates and insiders.

### 400 Earnings

This chapter will assist in analyzing an association's financial condition. It covers objectives, procedures, and references for examining the association's financial record keeping and reporting methods and operations analysis. The chapter also discusses present value analysis.

### 500 Liquidity

This chapter provides assistance in assessing liquidity and the funding risk confronting an association. It includes material on funds management, liquidity management, and investment activities. The chapter also discusses the Government Securities Act, Payments Systems Risk, and Regulation D.

### 600 Sensitivity to Market Risk

This chapter provides assistance in assessing the market risk confronting an association. It includes guidance on managing interest rate risk and hedging.

### 700 Other Activities

This chapter addresses review of the thrift's or subordinate organization's activities in insurance, real estate development, and networking arrangements.

This chapter also provides guidance in the evaluation of risk that operating subsidiaries, service corporations, and lower-tier entities (such as joint ventures or limited partnerships) pose to the association and thereby the insurance fund.

### 1000 Compliance

The Compliance chapter covers the new Compliance Oversight Examination Program (COEP); fair lending laws and regulations such as the Equal Credit Opportunity Act and the Fair Housing Act; the consumer protection laws and regulations such as the Truth in Lending Act, Real Estate Settlement Procedures Act, and the Electronic Funds Transfer Act; the laws and regulations such as the Bank Secrecy Act, the Bank Protection Act, and the Community Reinvestment Act and regulations.

#### *FFIEC-Approved Procedures*

In many instances, you will notice that the Federal Financial Institution Examination Council (FFIEC) logo and approval appears at the bottom of the first page of a Compliance section addressing a law or regulation. This indicates that the entire section, including the examination objectives and procedures, has been approved for use by all the agencies represented on the FFIEC (the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, OTS, and the National Credit Union Administration).

## SECTION ORGANIZATION

Each handbook chapter contains several sections of examination material subdivided into different areas of review. For example, Chapter 300 contains a section for each area of review under Management.

Each handbook section has a unique three- or four-digit number that allows for easy identification and referencing of materials. For example, under Management Chapter 300, the number 310 references the section on Oversight by the Board. The program, questionnaire, and any work papers have the same 310 reference number. Handbook page numbers follow the same sequence; hence, the introduction for Oversight by the Board of Directors, Section 310, is handbook page number 310.1.

Each handbook section has a unique three- or four-digit number that allows for easy identification and referencing of materials.

Each handbook section contains a discussion of the subject area, regulatory references, a program that includes examination objectives and procedures, related questionnaires, and appendices, if applicable. The discussion below covers each of these areas. We also provide a list of common objectives and procedures that may prove valuable during the examination, even though they may not appear in every program.

## Subject Narrative

The narrative of each handbook section provides the specific guidance for a particular topic. It provides basic information such as OTS policy, a historical perspective, and subject overview. The narrative highlights significant regulatory concerns such as the nature and intent of enforcement actions that may be applicable to the review area. Subheadings appear where appropriate.

## References

Pertinent legislative and regulatory citations appear in the reference section, following the narrative. References to other relevant OTS guidance may appear where appropriate, including: various bulletins, agency instruction and class manuals, industry sources, and accounting pronouncements.

The reference list is comprehensive, providing resources beyond those needed on a day-to-day basis. When examining a state-chartered thrift, you should also refer to state regulations per regional office policy.

## Programs

The examination program serves as a guide for the orderly completion of an examination. Programs include objectives for the review of a subject and a series of procedures for completing those objectives. Examination programs also help determine the examination scope and organization, serve as documentation, and help establish conclusions and recommendations. Once completed, the program becomes part of the foundation for an effective quality review process.

We provide a detailed discussion of programs later in this Section.

## Questionnaires

Questionnaires appear at the end of some handbook sections. They are also available on the OTS Intranet.

### *General Questionnaires*

General questionnaires reflect standards for safe and sound operating procedures and may be useful for evaluating an association's operations. They include questions on internal controls that you must answer for purposes of objectivity. These questionnaires also assist in organization, act as memory joggers, and facilitate the review process.

It is not necessary to complete all questionnaires. You should complete only those pertaining to the examination scope and objectives.

### *Internal Control Questionnaire and Funds Transfer Questionnaire*

These questionnaires appear in the Preliminary Examination Response Kit (PERK) and copies are included as appendices in Thrift Activities Regulatory Handbook Section 340, Internal Control. The Internal Control Questionnaire contains questions about the association's internal control system. The Funds Transfer Questionnaire contains questions regarding the association's internal controls for funds transfers. The association should complete these questionnaires before the examination and it is your responsibility to verify the answers once you are onsite.

## Appendices

Some handbook sections include appendices. Appendices present additional sources of information applicable to the particular handbook section and may include forms, guidelines, or Q's and A's.

## EXAMINATION PROGRAMS

As mentioned earlier in this Section, examination programs serve as guides for the orderly completion of an examination via a set of objectives and procedures.

### Examination Objectives

This segment of the program helps you identify goals in reviewing a subject area. Each corresponding program, if applicable, lists objectives for easy reference.

Certain objectives are germane to the overall examination process and to virtually every examination section. You may wish to review these common objectives during an examination, as they may not appear in other handbook sections.

*Common Objectives*

- Document the effectiveness of an association's operations.
- Determine compliance with laws and regulations.
- Determine the adequacy of and adherence to association policies and procedures.
- Assess management's expertise and ability to manage the association's affairs.
- Assess the oversight and ensure that management and the board are receiving complete and accurate reports.
- Verify that an acceptable system of records and internal controls is in place.
- Assess the effect of anticipated internal and external changes on the association.
- Assess the association's ability to meet its future needs (for instance, fund growth, provide capital, absorb losses).
- Identify any actual or potential undue risk to the association.
- Report examination findings, presenting analysis and conclusions regarding the association's overall condition, trends, and prospects for future viability.
- Report concerns of material risk and initiate corrective action when needed.

**Examination Procedures**

Examination procedures appear in a top-down fashion in three categories – Levels I, II, and III. Each category represents a different level or depth of review. The top-down approach begins with a review of policies, procedures, and internal controls while focusing on the safety and soundness of the association (Level I). With this approach, you can expeditiously assess the degree of risk in each area of a particular association's operations early in the examination. You can also better determine the depth of review and the procedures (Levels II and III) needed.

The programs serve as guides and reminders throughout the examination process. For those with less experience, the programs are especially useful guides for effectively completing the assigned examination phase. For those with more experience, the programs tend to be reminders of review areas during each phase of an examination.

Not all programs will apply to an association. Further, of those that apply, you most likely will not need to complete all the procedures. The examination scope should help determine the level of review and procedures you need to conduct in each area. See Examination Handbook Section 060, Examination Scheduling, Scoping, and Management. When selecting programs and procedures for review, you must



use a risk-focused examination approach. A risk-focused approach allows you to accomplish the following tasks:

When selecting programs and procedures for review, you must use a risk-focused examination approach.

- Highlight the concerns in the scope and any other problems found during the review.
- Assess the safety and soundness of the association.
- Update and support the CAMELS composite and component ratings.
- Assess the association's compliance management program.
- Update and support the Compliance rating.

Use sound professional judgment to ensure that the depth of review is sufficient to accurately assess the association's condition, but is not excessive. The following discussion focuses on general procedures, the three levels of procedures, and the national policy guidelines for their use.

### *General Procedures*

Although examination subject areas differ greatly, certain procedures are applicable to any phase of an examination. A list of procedures that is common to the overall examination process and to virtually every examination section appears below. You may wish to review this list when completing an area of review, as the procedures may not appear in other handbook sections or programs.

Gather data:

- Review previous Report of Examination (ROE), PERK documents, exceptions, and work papers.
- Review internal and external audit reports and related management letters.
- Review current year's scope, supervisory correspondence, and interagency data.
- Consider regulatory policy associated with area of review.
- Set forth special considerations pertinent to the areas of examination.
- Obtain association's management reports and written policies and procedures.

Set scope (see also [Examination Handbook Section 060](#)):

- Establish a clear understanding of examination objectives.
- Determine whether management corrected any deficiencies mentioned in the previous ROE, audit reports, and supervisory correspondence.
- Perform analytical review procedures on financial data:
  - Identify new or unusual transactions requiring modified examination procedures.
  - Indicate areas of greatest concern.
- Consider risk-focused or tailored examination procedures.
- Tailor examination program to meet individual needs.
- Consult with other examiners; take the nature of their initial findings into account in determining the procedures to perform.
- Determine if expanded procedures are necessary.
- Develop additional procedures not covered in the Handbook, if necessary.
- Perform only those procedures necessary to achieve program objectives.

Perform procedures:

- Interview association personnel.
- Evaluate policies and procedures.
- Spot check the reliability and accuracy of reports.
- Test the association's procedures.
- Identify any material changes in operation or policy since previous examination.
- Evaluate trends.
- Research significant variations from the previous examination to determine if there is cause for concern.
- Obtain explanations for any significant matters.

Assess management:

- Review adequacy of management reports to the board.
- Determine the extent of directors' involvement in monitoring performance.
- Review management's plan for future operations.
- Interview management and staff to determine if they have adequate knowledge of policies and procedures.
- Determine sufficiency of training and expertise to implement procedures.
- Determine if management is communicating and regularly updating policies and procedures.

Formulate conclusion:

- Keep the examiner-in-charge (EIC) informed of progress.
- Discuss concerns with other examiners.
- Identify, and determine significance of, regulatory violations and deficiencies.
- Discuss findings with management.
- Determine adequacy of management's response to problem issues.
- Consider possible strategies for corrective action and develop a recommended course of action.

Conduct post review activities:

- Review work to ensure the examination team satisfied examination objectives.
- Summarize results and conclusions.
- Draft comments, including scope and recommendations.
- Assign ratings, if applicable.
- Ensure that you properly cross reference work papers and support substantive findings and conclusions.
- Update the Electronic Continuing Examination Folder (ECEF) and Regulatory Profile, if applicable. (See [Examination Handbook Section 040](#).)

- Update the Continuing Examination File (CEF), if applicable. (See Examination Handbook Section 060.)
- Enter violations of laws and regulations under the Violations tab in the EDS/ROE system.
- File exceptions in the General File (GF).

### *Level I*

Level I procedures focus on the review of examination scoping materials and association documents, such as policies, procedures, and the compliance management program and self-assessment. After the Level I review, interview personnel to determine if practices conform to written guidelines. You should also confirm any other preliminary findings.

If you uncover significant items of concern during Level I analysis, or if you identify significant problems during preexamination monitoring and scoping, you may need to use

Level II procedures. In certain circumstances, you may need to complete Level III procedures as well.

<u>Examination Focus</u>
Level I – Review of exam scoping materials and association documents
Level II – Analysis of association documents
Level III – Transaction or file analysis

### *Level II*

Level II procedures focus on the analysis of association documents such as loan files, management reports, and supporting financial records. You should select and complete Level II procedures when Level I procedures do not reveal adequate data to support a conclusion for a review area. In the Compliance area, you must determine if the association's compliance management program adequately fulfils the remaining SMAART criteria, that is systems, monitoring, accountability, responses, and training. You may develop an independent analysis of asset values at this level as well as independent verification of other items.

Level I and selected Level II procedures normally provide a comprehensive analysis to support conclusions. These procedures do not include any significant auditing procedures. If you cannot rely on the data contained in association records, Level III procedures may be necessary.

### *Level III*

Level III procedures include extensive transaction or file analysis. In the Compliance area, this includes completion of selected FFIEC and/or OTS examination procedures.

Level III also includes steps that auditors usually perform. Although certain situations may require Level III procedures, it is not standard practice for you to duplicate the testing efforts of auditors.

Again, it may not be necessary to complete every program or every procedure within a program. You must use discretion in determining which programs and procedures are necessary to address the scope and reach a sound conclusion. In some situations it may be appropriate to customize existing procedures. In other situations you may perform procedures outside a program to achieve the most efficient and meaningful analysis. You should document any decisions to deviate significantly from the initial scope instructions or to modify existing procedures on the relevant programs.

### *Summary, Recommendations, and Comments*

In this last section of the program, summarize the following:

- Examination scope, including identification of any procedures used that are not already printed on the program.
- Salient findings and a conclusion regarding the strengths and weaknesses of the association's operations in the particular review area.
- Recommendations for corrective action, which may include a statement about the adequacy of management's response and commitments. *Note:* You should address any recommendation for revising a formal supervisory action in a separate memorandum.

Your work papers should support all substantive findings regarding the overall condition of the association. It may be useful to attach copies of draft comments or schedules included in the ROE to this portion of the program.

### Programs and Work Papers

Properly prepared examination programs and work papers are essential to the examination process. OTS relies on work papers to support the conclusions and findings set forth in the ROE. The reader determines conclusions about the effectiveness of the OTS examination process, in part, by the adequacy of work paper documentation. Proper documentation of procedures and subsequent conclusions in the programs leaves an effective audit trail for users of the completed programs. Moreover, legal staff often uses examination work papers to support the OTS's position in litigation matters.

You are required to support all the applicable elements reviewed under each CAMELS component and Compliance either in the work papers or in a conclusion documented on the appropriate program. In addition, the conclusion for each work paper or area of review should summarize the examination findings, support the composite rating (in addition to the component rating), and indicate if any corrective or enforcement action is necessary.

You should avoid excessive documentation and include only information that is relevant or may require follow-up.

You should avoid excessive documentation and include only information that is relevant or may require follow-up. Time spent recording extraneous information

would be better spent examining high-risk areas. To facilitate any follow-up review that may be necessary, you should also document the name and title of persons or a description of the records from which you obtained the information. Schedules prepared by the association should be clearly marked as such.

You should include the following items in work papers and programs, as appropriate:

- Statement of purpose, title, or heading.
- Scope of review.
- Sampling criteria used.
- Procedures performed.
- Legend or explanatory footnotes, if necessary.
- Results of testing.

The examination programs allow space to the right of each procedure to record a work paper cross-reference. This will lead the reader to supporting documentation found either under the same topic or in another program. You must support all substantive conclusions. Additional space between each procedure allows you to include any pertinent information.

The lower right-hand corner of each program contains an index block for the following items: Examination Date, Prepared By, Reviewed By, and Docket Number. Fill in each of these items before completing the examination. You should also include this information in your work papers.

The EIC or designee must review and initial all work papers, indicating agreement with the conclusions reached and ensuring that assistants complied with the applicable documentation requirements. You need only initial and date the first page of the TFR, UTPR, and other multi-page printed documents. The EIC should ensure that exam staff carefully checks all comments, charts, and appendices. At a minimum, the EIC's supervisor will review the work papers the EIC prepared and the supporting documentation for the report comments.

File work papers according to the OTS program number. To locate examination programs easily, you may use the Handbook table of contents or the program index. You may use the program index as a cover page for file folders. You should cross-reference information germane to the ROE or review process to supporting documentation.

### *Electronic Work Papers*

OTS recently introduced the electronic work paper database accessible via the EDS/ROE system. Follow your regional office instructions.

## Sources of Information

Following is a generic list of information sources that will help you successfully complete the programs.

### *OTS Documents*

- Laws and regulations.
- Transmittals.
- Regulatory and Thrift Bulletins.
- CEO Memos.
- Standard and supplemental accounting manuals.
- Published memos.
- OTS Professional Development materials.
- Uniform Thrift Performance Report (UTPR).

### *Regional Office Examination Materials*

- Previous ROEs, General File, and work papers.
- Correspondence from the regional office.
- ECEF and Regulatory Profile.
- CEF, if applicable.
- Thrift Financial Reports (TFRs).
- Regional office instructional manuals.

### *Association's Documentation*

- Completed PERK schedules.
- Business plan.
- Operating budget and forecasts.

- General ledger trial balance.
- Loan trial balance.
- Investment trial balance.

## *Reports and Minutes*

- Independent audit report.
- Internal audit report.
- Internal management and board reports.
- Securities and Exchange Commission (SEC) annual report, 10K, 10Q, and 8K (if stock association).
- Board of directors' minutes.
- Board committee minutes.
- Operating committee minutes.

## *New or Revised Policies, Procedures, and Corporate Documents*

- Compliance management program.
- Compliance self-assessment.
- Internal control policy.
- Real estate lending policies.
- Real estate appraisal policy.
- Environmental risk policy.
- Classification of assets policy.
- Investment policies.
- Interest rate risk policy.
- Asset/liability management policy.



- Interbank liabilities policy.
- Futures and options policy.
- Charter, bylaws.
- Security policy.
- Information security program (Gramm-Leach-Bliley Act § 501(b)).
- Bank Secrecy Act/ Anti-Money Laundering policy.
- CRA statement.
- Contracts (information systems, service bureau, employment, etc.).
- Contingency planning policy.
- Leases (office building, etc.).
- Payment systems risk policy.