

Office of Inspector General



Date: July 7, 2000
Audit Report No. 00-026

**Audit of the Division of Compliance
and Consumer Affairs' Community
Reinvestment Act Examination Process**

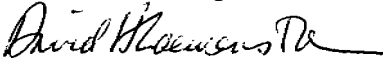


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DATE: July 7, 2000

MEMORANDUM TO: Stephen M. Cross, Director
Division of Compliance and Consumer Affairs

FROM: 
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Assistant Inspector General

SUBJECT: *Audit of the Division of Compliance and Consumer Affairs'
Community Reinvestment Act Examination Process
(Audit Report No. 00-026)*

The Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General has completed an audit of the Community Reinvestment Act (CRA) examination process as conducted by the Division of Compliance and Consumer Affairs (DCA). We performed this audit to determine whether DCA consistently applies CRA examination procedures within and among its regional offices and whether these procedures are applied in a manner that ensures the resulting ratings provide an accurate measure of the banks' performance.

We found that DCA's examination procedures do not provide specific guidance in some critical areas of the evaluation process in which we believe consistency is vital. Consequently, CRA examination procedures are not consistently applied by examiners within and among regional offices. We also found that the CRA Performance Evaluation reports (PE reports) do not comprehensively identify the credit needs of the communities in which the banks are operating. Additionally, the PE reports do not consistently include the types of comparative and analytical data in the analyses of the banks' small business lending performance that would enable the reader to understand the basis for the examiners' conclusions. As a result of the lack of information related to the credit needs of the community and small business lending data, it is difficult to determine if the resulting ratings provide an accurate measure of the banks' performance. In addition, we determined that internal control procedures over the CRA examination review process and workpaper maintenance need to be enhanced to ensure consistent presentations of CRA data and complete analyses to support the examiners' conclusions.

We also concluded that DCA generally conducted Community Reinvestment Act (CRA) performance evaluations in accordance with the FDIC CRA-related policies and procedures. We noted several instances where examiners did not fully adhere to the procedures; because these items were not significant, they will be addressed in a separate management letter.

BACKGROUND

The Division of Compliance and Consumer Affairs (DCA) performs Community Reinvestment Act (CRA) examinations on all non-member state banks as a part of the compliance examination process. The required frequency of CRA examinations depends on a bank's size and previous

ratings. Unlike the reports that are prepared for compliance examinations, each bank must make its CRA PE report available to the public. 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. In addition, the FDIC can use the CRA ratings as a factor in considering various bank applications.

Regulatory Requirements

The Community Reinvestment Act was enacted as Title VII of the Housing and Community Development Act of 1977,¹ 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, non-member financial institutions. The FDIC Division of Compliance and Consumer Affairs (DCA) was established in 1994, and is responsible for evaluating the CRA performance of FDIC-supervised banks through its CRA examination process.

In 1995, the federal banking agencies (FDIC, Federal Reserve System, and Office of the Comptroller of the Currency), and the Office of Thrift Supervision jointly amended their regulations implementing CRA. The regulations were amended to emphasize performance rather than process, promote consistency in evaluations, and eliminate unnecessary burden. The amended rules focus on assessing how banks meet the lending, investment, and service needs of the communities where they accept deposits and require that examinations focus on tangible performance-based results rather than on procedures.

The regulatory agencies published uniform interagency CRA examination procedures on November 13, 1995. Under these procedures, each bank has the option of being evaluated under the standard assessment method, or based upon the bank's own CRA strategic plan. For large banks (with assets of \$250 million or more, or belonging to a holding company with \$1 billion or more in assets), the standard assessment method includes an evaluation of a bank's lending, investment, and service performance in the communities and neighborhoods in which it operates. For small banks, the assessment method only focuses on evaluating a bank's lending performance in its local community. The examination procedures for small banks went into effect on January 1, 1996, and the procedures for large banks went into effect on July 1, 1997. Appendix I details the CRA performance evaluation criteria.

Under CRA, all regulated financial institutions have a continuing and affirmative obligation to help meet the credit needs of their entire communities, including low- and moderate-income neighborhoods, consistent with safe and sound operations. The regulated financial institutions are required to demonstrate to their primary regulators that their deposit facilities serve the

¹ The Community Reinvestment Act was amended by the Gramm-Leach-Bliley Act of 1999 (the Act) to, among other things: prohibit financial holding companies from being formed unless their insured institutions receive and maintain a satisfactory CRA rating; require public disclosure of bank/community CRA-related agreements; and grant some regulatory relief to small institutions by reducing the frequency of their CRA examinations if they have received Outstanding or Satisfactory ratings. As a result of the Act, financial institutions with aggregate assets of not more than \$250 million are subject to routine examination no more frequently than every 60 months for institutions rated Outstanding, every 48 months for institutions rated Satisfactory, and as often as deemed necessary by the appropriate federal banking agency for institutions rated less than Satisfactory.

convenience and needs of the communities in which they operate. The convenience and needs of the communities include the need for credit services as well as deposit services. Although CRA encourages federally-insured financial institutions to lend in the entire community, including low- and moderate-income neighborhoods, the banks are not required to extend high-risk loans that jeopardize the banks' safety. Furthermore, there are no CRA provisions with which the banks must comply other than data reporting requirements. Consequently, the federal banking agencies do not have any enforcement powers covering CRA activities. However, CRA requires that the federal bank regulatory agencies evaluate institutions' CRA performance, and requires that these evaluations be disclosed to the public and considered by the agencies in reviewing bank applications for new locations, acquisitions, mergers, etc.

Also, CRA requires large institutions to maintain and submit data related to lending to small businesses and small farms. For the purposes of CRA evaluations, banks are also required to comply with Home Mortgage Disclosure Act² reporting requirements.

CRA Evaluation Process

DCA examiners generally perform CRA evaluations as a part of the compliance examination required of non-member state banks. DCA estimates that examiners spend approximately 49 hours on average conducting a CRA evaluation, a process that can include evaluating as many as 15 separate performance criteria. Examiner judgment is a vital part of assessing a bank's performance in relation to a community's needs and the performance of comparable institutions serving the same or similar communities.

As noted in Appendix I, CRA evaluations consist of analyses of the lending, investment, and service performance of large banks, as it relates to low- and moderate-income areas and households. For small banks, only the lending test is required. The lending test, which is common to both large and small bank evaluations, involves the compilation and analysis of a bank's mortgage, small business, small farm, and/or consumer lending data, based on the composition of the bank's loan portfolio. The lending performance is then compared to the lending opportunities and loan demand in the area in which the bank is operating and to the lending performance of other similar banks in the area. In addition, large bank CRA evaluations include analyses of the types of investments made in the community and the retail banking services provided in low- and moderate-income areas. The results of the analyses are reported to regulators and to the public through CRA Performance Evaluation reports, which banks must make available to the public upon demand.

² The Home Mortgage Disclosure Act (HMDA) requires banks located in metropolitan statistical areas to collect data regarding applications for, and originations and purchases of, home purchase and home improvement loans, including refinancings of both, for each calendar year. Within 30 calendar days after the end of each calendar quarter, these transactions must be recorded on a loan application register in the format prescribed by the law. HMDA data is used by examiners to assess the mortgage lending activities of banks during CRA performance evaluations. The federal banking agencies have the authority to enforce compliance with the provisions of HMDA.

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed an audit of the CRA examination process to determine (1) whether DCA consistently applies CRA examination procedures within and among its regional offices and (2) whether these procedures are applied in a manner that ensures the resulting ratings provide an accurate measure of the banks' performance.

To accomplish the audit objectives, we reviewed large and small bank CRA performance evaluations started between January 1, 1998 and December 31, 1998 on 57 banks ranging in asset size from \$10 million to \$4 billion. During 1998, DCA started 1,983 CRA examinations, with 98% of the banks receiving ratings of Outstanding or Satisfactory. Appendix II provides a description of the universe of 1998 CRA examinations and our audit sample.

Our audit work included reviewing DCA policies and procedures, CRA Performance Evaluations for 57 FDIC-supervised institutions, and a sample of CRA examination workpapers. In addition, we discussed the process for conducting CRA performance evaluations with DCA officials in the headquarters office, as well as regional management and examiners in the Boston, Chicago, and Memphis Regional Offices. We also discussed the availability of demographic data with Division of Insurance (DOI) representatives at both the regional and headquarters levels. We reviewed the FDIC Compliance Examination Manual and supplemental policy memos to identify the procedures related to CRA examinations, including but not limited to pre-examination planning, onsite examination procedures, sample and data verification requirements, and related workpaper requirements. Our fieldwork also included a review of CRA regulations and comparisons of the regulations to DCA policies and procedures.

We obtained CRA examination hours and summary information from the Compliance Statistical System (DCA's examination tracking system). We also obtained copies of CRA Performance Evaluations from the DCA CRA Performance Database, and ratings summaries from the DCA Management Reporting System. We did not test the reliability of these systems as a part of this audit. The audit was conducted in accordance with generally accepted government auditing standards for performance audits. We conducted our fieldwork from April 1999 through March 2000.

RESULTS OF AUDIT

We found that specific guidance is needed in a number of critical aspects of the CRA performance evaluation to ensure consistency in the analysis and presentation of data. One of the most critical needs for specific guidance is in the presentation of a bank's loan portfolio, the basis for much of the evaluation process. We found inconsistencies in and among regional offices in how loan products are grouped and identified in CRA performance evaluation reports (PE reports). In turn, this leads to concerns about how examiners select loan products for analysis. We also identified differences in how examiners present assessment area loan concentrations and small business analyses. We understand that examiner judgment plays a vital part in the evaluation process; however, the consistency of the application of procedures is essential in ensuring that appropriate analyses are conducted and that the presentation of data in PE reports is consistent.

We also found that the inclusion of more comparative and analytical data in the PE reports is needed to better explain the basis for examiners' conclusions and ratings. The PE reports in our sample do not consistently identify the credit needs of the communities in which the banks are located, although FDIC procedures require examiners to conduct community contacts with local community groups, government entities, financial intermediaries, civil rights groups, consumer rights groups, or business and labor groups. We also found that the PE reports do not consistently include the types of comparative and analytical data in the small business lending analyses that would enable the reader to understand how an examiner reached his/her conclusions. As a result, it is difficult for the reader to determine the credit needs of the community and, therefore, whether the resulting ratings provide an accurate measure of a bank's performance in meeting these needs.

In addition, we believe the internal controls related to the supervisory review of PE reports and workpaper requirements need to be enhanced. Currently there are no comprehensive requirements for reviews of PE reports or for the maintenance of supporting workpapers. Although CRA examination procedures require that the PE reports be written in a manner that supports the conclusions in the reports, enhanced controls are needed to ensure that the appropriate data was used, thorough analyses were conducted, and proper support for conclusions and ratings is maintained.

ENHANCED PROCEDURES WOULD HELP TO ENSURE CONSISTENT PRESENTATION OF INFORMATION IN THE CRA PERFORMANCE EVALUATIONS

CRA examination procedures are designed to test a bank's performance in meeting the lending, investment, and service needs of communities in which the banks are operating and require examiners to focus on tangible performance-based results. We found that the FDIC examination procedures do not provide specific direction to examiners in several areas, allowing examiners so much flexibility that performance tests are inconsistently applied among regional offices and even among field offices within a single region. Within the PE reports, we identified significant differences in how examiners:

- describe the bank loan portfolio;
- justify the selection of various loan portfolio assets chosen for analysis;
- present assessment area residential and small business loan concentrations; and
- present small business lending analyses.

The flexibility given to examiners results in reports that are inconsistent and that could give the public a misperception of a bank's performance. Although the CRA procedures are designed to allow for examiner judgment, we believe there are certain areas that should be handled consistently among regional and field offices. We also believe this consistency will provide the public with a clearer assessment of bank performance.

Description of Bank Loan Portfolio

The process of selecting loan products for analysis begins with the examiner's description of a bank's loan portfolio. Examiners use data from standard Call Reports submitted to the FDIC by all insured institutions, but there is no guidance on how the data is to be presented in the PE report. The CRA performance evaluation procedures instruct examiners to list the primary types of loans by name and percentage of dollar volume or to include a table if there is a large volume of products.

We found that the methods used to describe bank loan portfolio assets varied within and among the three regional offices we reviewed. All of the PE reports we reviewed contained a description of the composition of the loan portfolio in some format. However, we found that in 24 cases (11 large bank PE reports and 13 small bank PE reports), the examiners combined the values from two or more loan portfolio asset types and represented them as one value in the PE report. In 19 of these cases (8 large and 11 small), the PE reports did not explain which Call Report asset types were grouped and labeled as one category in the PE report.

The following examples demonstrate the various ways examiners grouped loans in the PE reports we reviewed:

- In one PE report, "Mortgage Loans" included all loans for construction and development, commercial real estate, multifamily residential, 1-4 family residential, home equity, and farm land. Farm loans were included with "Consumer and Other Loans."
- In a second PE report, farm land and farm loans were combined and reported as "Agricultural" loans. Only 1-4 family residential loans were reported as "Residential Real Estate." Commercial real estate, commercial and industrial loans, and multifamily residential real estate loans were combined and reported as "Commercial" loans.
- In a third PE report, "Residential Mortgage" loans included construction and development, commercial real estate, and farm land loans.

These are but three examples of the various ways examiners combined Call Report data for inclusion in the PE reports. The resulting presentation of loans in the PE reports served as the basis for selection of loan products for analysis. We believe that the inconsistent grouping of loan products from the Call Report—particularly residential mortgage and farm lending—can result in analyses that distort the analysis of a bank's performance under CRA.

We found that in one regional office we reviewed, examiners did not combine loan products for presentation in the PE report. In this region, examiners presented loan data in the PE exactly as reported by banks in Call Reports. Call Report data is defined so that banks report consistent information. Without further guidance on combining loan products, we believe this is a better method of presenting a bank's loan portfolio.

We believe consistent presentation of data is needed to avoid confusing readers when PE reports are made public and would be beneficial when FDIC uses the CRA ratings to evaluate banks' applications for new locations, acquisitions, mergers, etc.

Selection of Loan Portfolio Assets for Analysis

In reviewing our sample of CRA evaluation reports and Call Report data, we found that examiners generally selected the largest loan group by dollar volume for the lending performance analysis. As explained in the previous section, examiners combine various asset types shown in Call Reports into a single category for analysis. Consequently, examiners can determine the size of a loan category, thereby influencing whether or not it is reviewed as part of the CRA performance evaluation.

DCA small bank risk-scoping examination procedures require examiners to limit the sampling universe to no more than two loan products. The guidelines further state that if a loan group is omitted from the analysis, the rationale for omitting it is required in the PE. The large bank CRA examination procedures state that “Whenever two or more product lines represent similar percentages of the portfolio or of originations and the examiner elects to evaluate the bank on only a portion of these product lines, the rationale for selecting one product line over another should be discussed in the public evaluation.”

During our review of the PE reports and Call Report data for the banks in our sample, we determined that the rationale for selecting and reviewing certain loan products was not always included in the PE. Specifically, we found that out of the 57 banks in our sample:

- 4 PE reports provided reasons for the exclusion of certain loan products from the examiners’ analyses;
- 1 PE stated that the largest loan group was used; and
- 1 PE stated that the product selection was based on the volume of originations.

Other than these six reviews, we consistently found that the PE reports did not explain the rationale for selecting one product line over another for analysis.

DCA examiners generally selected the largest loan group by dollar volume for the lending performance analysis. However, according to DCA guidance, consideration should be given to the current lending activities in the institution, and recognition should be given when institutions have shifted emphasis in lending patterns. Consequently, it may be more reasonable to analyze the loan category with the largest growth and most activity, even if it was not the largest loan category.

Presentations of Assessment Area Loan Concentrations

During the performance evaluation, examiners are required to identify the concentration of bank loans within and outside its assessment area for each loan type selected for evaluation. However, the examination procedures are not specific as to how this data should be calculated and presented.

In identifying the concentration of the bank’s loan products within and outside of its assessment area, FDIC Compliance Examination Manual procedures for large and small bank PEs require examiners to identify the dollar amount and number of each loan type under evaluation. In

addition, the large bank procedures require the examiner to calculate the percentages of concentration both within and outside of the assessment area for each loan type. Examiner discretion can be exercised to summarize the different product lines into a single ratio provided the ratio does not disguise substantive or relevant differences between the loan products.

Because examination policies allow examiners to determine the method of presentation for assessment area loan concentrations, there are inconsistencies not only between regions, but within regions as well. In our sample we found:

- For large banks, 15 of the 25 PE reports provided separate percentages for lending related to residential and small business loans, 4 provided one total percentage for both loan categories, and 6 PE provided both separate and combined percentages.
- For small banks, 11 of 32 PE reports provided separate percentages for lending related to residential and small business loans, 18 provided one total percentage for both loan categories, and 3 provided both separate and combined percentages.

These varying presentations of the data from the assessment area lending analyses do not provide consistent information to the public. In addition, in instances where only the combined percentages are shown, the reader is unable to discern the actual dispersion of the evaluated loan types within the assessment area. We believe that a presentation showing both separate percentages for residential and small business loans and an aggregate percentage for all loan categories is more informative and better serves the public interest by providing a more accurate picture of the bank's lending efforts.

Small Business Lending Presentations Were Inconsistent

CRA performance evaluation procedures do not provide specific criteria for when small business and farm lending analyses should be conducted, and to what extent. As a result, analyses are not always conducted even when the commercial lending activities, including small business and farm loans, appear to be material to the bank's portfolio. Moreover, the content of the small business and farm lending analyses varies among PE reports and does not always provide enough information to support the examiner's findings.

Criteria for Small Business and Farm Loan Analysis

One of the primary criteria for evaluating both small and large bank CRA performance is the level of lending to small businesses and farms of different sizes. FDIC regulations define small business and small farm loans as loans secured by non-farm nonresidential property where the original amount of the loan is \$1 million or less, if a business loan, or \$500,000 or less, if a farm loan." The Large Bank Reference Guide (dated December 19, 1997) states that examiners should generally include all business and farm loans originated during the reporting period when analyzing small business and farm loans, since the data are collected and reported by the institution.

We found that examiners at different field offices and regions are handling small business/farm lending differently during the CRA evaluations. The following examples demonstrate two of the ways examiners view these types of loans during examinations:

- For one small bank, the PE did not contain a separate review of farm loans or show farm loans as a percentage of the total portfolio. As detailed in the PE, real estate loans totaled 63% of the total portfolio, with the remainder in consumer loans (17%), commercial loans (11%), and all other loans (9%). Based on our calculations from the bank's Call Report dated June 30, 1998, farm-related credits accounted for 20% of the total portfolio. The farm real estate loans were grouped with and analyzed as a part of real estate loans.
- In a second small bank PE, the PE did not contain an analysis of the small farm lending although farm loans represented 50% of the bank's loan portfolio. The lending review included samples of residential loans, commercial loans, and consumer loans representing 24%, 10%, and 15% of the portfolio, respectively. No sample was taken of farm loans, and, therefore, no analysis was done of small farm lending.

CRA examination procedures do not provide guidance to examiners for determining when to conduct a separate analysis of small business and farm lending. As a result, small business and farm loans are sometimes overlooked in the CRA reviews.

Format of Data Contained in Small Business Analyses

In reviewing the PE reports, we found that the presentations of small business data related to the size of the loans and business revenues were inconsistent. The FDIC Compliance Examination Manual lists the following factors that examiners should consider when evaluating small business and farm lending within an area according to borrower characteristics:

- Number and dollar volume of small loans originated to small businesses or farms by loan size of less than \$100,000; at least \$100,000 but less than \$250,000; and at least \$250,000 but less than or equal to \$1,000,000.
- Number and dollar amount of small loans to small businesses or farms that had annual revenues of less than \$1 million compared to the total reported number and dollar amount of loans to businesses or farms.

In the analysis of small business and farm lending, the Large Bank Reference Guide (dated December 19, 1997) states that examiners should consider both the size of the loan and the level of gross annual revenues of the small businesses. The Guide describes as a weakness, PE reports that do not provide an analysis of small business loans by loan size. The Guidance for Small Bank Public Evaluations (dated October 29, 1996) does not require the use of loan sizes in the analysis of small business and farm lending. The guidance states that the loan sizes can be used as a proxy when the data needed to do a distribution analysis is not available in the loan files.

The CRA regulation specifies that analyses of banks' lending performance related to borrower characteristics will include the number and amount of small business and farm loans to borrowers with gross revenues of \$1 million or less. The regulation does not specifically state how this distribution should be detailed. The DCA Large Bank Reference Guide states that

“Since institutions are only required to indicate whether a small business or farm has annual gross revenues of \$1 million or less, it is necessary to use sampling procedures in order to further stratify income levels.”

In assessing a bank’s small business lending by loan size and by the revenue size of the borrowers, many of the PE reports presented just 2 broad categories of small business lending data. Specifically:

- For the 57 banks in the sample, 6 of the 25 large bank PE reports, and 26 of the 32 small bank PE reports grouped small business loan sizes into only two broad categories of under and over \$1 million.
- In 18 large bank PE reports and 6 small bank PE reports, business revenue breakdowns were labeled according to two broad categories: less than \$1 million and greater than \$1 million. A detailed breakdown of the various revenue sizes within the less than \$1 million range was not provided.

However, there were 19 large bank PE reports and 6 small bank PE reports in our sample that further stratified small business loans and borrower revenues into various subgroups, such as: (1) less than \$100,000; (2) \$100,000 to \$249,000; and (3) \$250,000 to \$1,000,000. This breakdown gives a much better representation of the number and amount of loans that are extended to small businesses and farms. The needs and repayment capabilities will vary even among various subgroups of small businesses and farms, and an accurate assessment of how the bank meets those needs is imperative.

The guidance for both large and small banks does not specifically require the breakdown of the various revenue categories for small businesses with income of less than \$1 million. Although the Large Bank Reference Guide does advise examiners to categorize small businesses by loan size, this still does not provide an adequate assessment of the size of the businesses requesting the loans. The grouping of loans into two large revenue categories does not convey an accurate picture of how the bank is meeting the credit needs of small businesses and farms. Among small businesses, the credit needs are different and the repayment capabilities will vary. However, when the business revenues and corresponding loan amounts are categorized into several categories less than \$1 million, this provides a more realistic picture of the size of businesses serviced by the bank and their individual credit needs. Although not required, providing additional guidance addressing these areas would improve the consistency of data presentations and be more informative to the public.

Recommendation:

Although examiner judgment is necessary in all CRA evaluations, some aspects of the CRA examination guidance need to be more specific. Examiner judgment should be eliminated in those areas that could result in inconsistent CRA evaluations. Therefore, to further ensure that CRA evaluation reports fully support the ratings given to institutions, we recommend that the Director, DCA:

- (1) Provide guidance to examiners that results in consistent examination procedures and reports in the areas related to: description of bank assets and selection of loan products for analysis; presentation of assessment area loan concentrations; and presentation of small business analyses.

MORE COMPARATIVE AND ANALYTICAL DATA WOULD HELP TO BETTER EXPLAIN THE BASIS FOR EXAMINERS' CONCLUSIONS AND RATINGS

We found that the CRA performance evaluation reports (PE reports) do not comprehensively identify the credit needs of the communities in which the banks are operating. Also, the PE reports do not consistently provide comparative and analytical data when discussing the institutions' small business lending activities. By identifying the credit needs of the community and consistently including comparative and analytical data in the evaluation of an institution, DCA can assure the public that performance has been measured relative to the credit opportunities within the community and the bank's responsiveness to those opportunities.

Use of Community Contacts to Identify the Credit Needs of the Community

As part of the CRA performance evaluation, examiners are required to conduct community contacts. According to DCA management, community contacts are an integral part of the CRA examination planning process because they are designed to help to identify the lending needs of a community. Also, according to the DCA Large Bank Reference Guide (dated December 19, 1997), establishing that examiners met with representatives of the community to better understand the needs of the assessment area and obtain public perceptions of the institution lends greater support to the assigned ratings.

The community contact procedures contained in the FDIC Compliance Examination Manual provide examiners with detailed instructions related to:

- how to prepare for contacts, including the background information that should be assembled;
- the specific types of potential contacts, such as local community groups, governmental entities, financial intermediaries, civil rights and consumer rights groups, and business and labor groups;
- detailed questions to ask during the interview, based on the varying types of contacts; and
- how to document new contacts, or update or supplement existing community contact forms.

During our review, we found that only 8 PE reports out of 57 in the sample contained summaries of the discussions held with community contacts. Although 2 additional PE reports in the sample referred to the community contacts, the reference was limited to one specific aspect of the bank's lending activity, and a summary of the information received was not provided. We also reviewed the Pre-Examination Planning memos we received for 50 of the PEs in our sample and determined that in 8 cases there was no mention of whether or not the examiners intended to conduct community contacts. In addition, in 16 cases the examination hour tracking reports did not reflect that any hours had been spent by examiners conducting community contacts.

According to the DCA field office supervisors and examiners we interviewed, the information obtained from community contacts is not always useful. One field office supervisor stated that: (1) the community contact form used during interviews is not designed to obtain the type of information that would be useful during the evaluation and should be revised and (2) the examiners should be given some type of interview skills training to assist them in obtaining pertinent information. According to the examiners we interviewed, the actual amount of time spent by examiners in identifying and conducting community contacts can be significant, and the examiners can devote a great deal of time to educating the contact person about the FDIC rather than obtaining significant data. Examiners also informed us that it is very difficult and very time consuming to identify appropriate community contacts, particularly for banks located in rural areas. It was suggested that the function could be better handled by the DCA Community Affairs Officers at the regional office level. In addition, examiners stated that contacts are sometimes reluctant to provide information, and that often the data obtained from the contacts is not very informative.

DCA management informed us that community contacts are a very important aspect of the CRA performance evaluation because examiners need this type of information to determine the scope of the evaluation and to assess bank performance in view of the community's needs. The DCA Director stated that it is important for the examiners to make these contacts and the Division is in the process of revising the guidance related to community contacts. In addition, a Federal Financial Institutions Examination Council interagency project has been initiated to revise the forms used to record the information obtained during community contacts.

Limited Comparative and Analytical Data for Small Business Analyses

Although the PE reports provided data related to the bank's lending performance, they did not fully discuss lending opportunities or discuss the bank's small business lending performance in relation to data for peer or similarly-situated institutions, or the average size of businesses in the assessment area.

The Large Bank Reference Guide directs examiners to describe in the PE report the thought process behind their conclusions by explaining the relevant factors considered and describing the basis for their conclusions, to better enable the public to understand the examiner's rationale. It also states that examiners should stratify income levels according to information obtained in the performance context relative to the average size of businesses or farms in the assessment area. The Guide describes well-written PE reports as those that were supported using information from the performance context.

We reviewed the small business lending analyses for the 19 large banks and the 9 small banks in our sample that were Home Mortgage Disclosure Act (HMDA) reporters. For 12 of the large banks and all 9 of the small banks, the PE reports did not contain aggregate small business/farm data. We also noted that for the 19 large banks and the 9 small bank PE reports, no additional analysis or insightful information was included in the small business/farm analyses related to the bank's performance in relation to its competition or local lending opportunities. The analyses typically contained comments that only reiterated what was in the charts used to present the bank's lending information.

In most cases, the PE reports provide demographic and economic data in the sections of the reports that describe the bank and its assessment area. Also, in some instances the examiners provided the reasons for missing comparative data, such as extenuating circumstances due to the bank's performance context. In these cases, the information needed to understand the examiner's rationale for a rating was not included in the small business analyses.

According to DCA staff, one reason why the PE reports do not always contain informative analyses of small business and farm loans, even when these loan products appear to be material to the institution's loan portfolio, is the lack of comparative data available to assist the examiners in analyzing these lending areas. Although the PE reports provided some data related to the bank's small business or farm lending performance, they did not fully discuss the lending opportunities or the bank's lending performance in relation to peer or similarly-situated institutions, or the average size of businesses in the assessment area.

During discussions with field office examiners, concerns were expressed about the adequacy of data for reviews and analyses and the difficulty in obtaining comparative data. Examiners also expressed the need for additional guidance and specialized training related to identifying and analyzing the types of data needed to conduct small business analyses, particularly for small banks not located in metropolitan statistical areas. It was also stated that small business analyses are not a good indicator of a small bank's performance due to the lack of aggregate data to use for comparative purposes.

To assist examiners in conducting CRA performance evaluations, DCA initiated the Backroom Operations Assessment Team program (BOAT) in 1999. DCA created BOAT to reduce the time its examination staff spends doing "backroom operations" in connection with the examination process, such as collecting comparative information for analysis. The BOAT goals include:

- focusing the examiner's time and expertise on analyzing data rather than collecting data,
- providing a more efficient means of data collection and manipulation, and
- promoting consistency regarding the data used by examiners in pre-examination planning.

Final implementation of the program has been delayed primarily because the current CRA Tactician software contract is due to expire by the end of the year. Because the BOAT program will depend heavily on the information generated by the software, it appears prudent to wait until a new contractor is in place before BOAT training is started.

Recommendations:

The use of community contacts is a critical part of the CRA evaluation procedure. Input from the community is vital to understanding the community needs and an institution's efforts to meet those needs. In addition, PE reports that provide data related to the banks' lending opportunities and performance as compared to local competitors provides the reader a better understanding of the basis for the examiners' conclusions. To enhance the support for CRA PE report conclusions through the use of examiner contacts with community organizations and leaders and the use of comparative analytical data, we recommend that the Director, DCA:

- (2) Require examiners to include a separate section in the PE to summarize the results of the data obtained from community contacts.
- (3) Revise the policy related to community contacts to eliminate certain qualifiers (such as "if relevant" or "if any") that allow examiners to avoid including information gathered from community contacts in the PE reports.
- (4) Require that the PE reports provide data on the scope of the small business/small farm lending reviews and the basis for the examiners' conclusions.

CONTROLS OVER CRA EXAMINATIONS NEED TO BE ENHANCED

DCA lacks sufficient internal controls over the review of performance evaluations and the maintenance of supporting documentation to ensure consistent PE presentations and to ensure adequate analyses are conducted to support the PE conclusions. We noted that (1) there was little evidence the PE reports had been reviewed for control purposes and (2) the workpapers were not maintained in a manner that would readily support the examiner's ratings decisions. We believe the lack of certain controls contributed to the inconsistencies we identified in CRA performance evaluation reports (PE reports).

Performance Evaluation Review Process

According to the FDIC Compliance Examination Manual, Appendix K, the Examiner-in-Charge is ultimately responsible for the completeness and accuracy of both the Report of Examination and the supporting workpapers. DCA procedures do not require formal supervisory reviews of the PE reports, and the review process is not consistent among regional offices or field offices. During our review, we determined that the Field Office Supervisors (FOSs) are usually involved in the pre-planning phase of the evaluation and will review and approve the pre-examination planning (PEP) memos before the start of the evaluations. However, no formal review is required upon completion of the PE reports. According to FOSs we interviewed, in some cases the PE reports are not reviewed before being finalized and sent to the Regional Office. Also, the FOSs generally do not review the underlying documentation related to the PE reports, as this is considered the responsibility of the examiners.

Regional office review examiners are responsible for reviewing PE reports upon completion at the field office level. During discussions with regional office review examiners, we were told that their reviews of the PE reports include reviewing the PE for content, compliance with procedures, consistency, readability, understandability, and to ensure that assigned ratings are adequately supported by the information in the PE reports. However, the review examiners do not conduct quality control reviews of underlying data such as the Call Report data or detail on the bank's loan portfolio.

One of the three regional offices in our review has a Field Office Review Guidelines Manual for review of all compliance examination reports. However, upon review of the manual, we determined that the guidelines do not specifically address CRA performance evaluations, and a review of underlying data such as call data, loan portfolio, or PEP memos is not required.

In a second regional office, field offices use a Compliance Report of Examination Review Form. According to the form, its purpose is to provide constructive feedback on examinations. The form contains the following 6 items for the reviewer to address:

- Assigned ratings were adequately supported and the overall tone and language of the report was consistent with the findings.
- Outstanding formal/informal enforcement actions and/or agreements to make Truth in Lending restitution were adequately addressed.
- Write-ups were clear, well supported and completed according to policy.
- The report was checked for spelling and formatting errors, tie-ins between pages, mathematical calculations, and appropriate grammar and sentence structure.
- The report was completed and submitted to the Regional Office within established and reasonable time frames.
- Substantive changes made to this report were discussed by telephone with the Examiner-in-Charge.

The Compliance Report of Examination Review Form does not specifically address CRA performance evaluations. The review requirements of the form appear to focus on content, readability, and timing issues. The form does not require the review of any of the underlying documentation used to rate the institution, such as Call Report data, demographic information, comparative data for similarly-situated institutions, assessment area aggregate data, or community contacts.

Optional Workpaper Requirements

The FDIC Compliance Examination Manual states that examiners should prepare a summary of each regulation reviewed or each task performed, documenting the scope, time period, documents reviewed, and examiner conclusions. The manual also states that the workpapers provide a written record for the examiner's decisions and analysis of violations; comments and conclusions cited in the Report of Examination; and documentation of the examination procedures performed, compliance violations, and identified program weaknesses. Specifically, the FDIC Compliance Examination Manual, Appendix K, entitled Standardized Workpapers, states the following:

The use of standardized workpapers is optional. Documentation should contain sufficient information to enable an examiner having no previous connection with the examination to ascertain from them the evidence that supports the examiner's significant conclusions, judgments, and cited violations.... Workpapers which thoroughly and accurately document the criticisms and weaknesses of a financial institution are necessary to support any subsequent enforcement action or possible appeals of material supervisory determination.

During our review of the CRA examination workpaper files for the banks in our sample, we noted that the workpapers are not maintained in a manner that could be readily used to support the conclusions in the CRA performance evaluations. Based on our review of workpapers for 31 of the 57 banks in our sample, we noted that the following documents were not always included

in the workpapers to support the examiners' conclusions or to document management's review of the PE reports:

<u>Not Included in Workpapers</u>	<u>Number of PEs</u>
Examiner Comments and Conclusions	22
Regional Office Review Examiner Comments	21
Draft PE with Field Office Supervisor Comments	20
Written Examiner Summaries	18
Staff/Examination Hours	9

Since workpaper requirements are optional, the workpapers do not always provide a clear picture of the examination process. Consequently, it was difficult to determine whether the appropriate analyses were conducted to ensure an accurate measure of the banks' performance. According to DCA review examiners and field office supervisors, workpaper reviews were not essential, the workpaper requirements contained in the FDIC Compliance Examination Manual are optional, and the PE reports should be written in a manner that would provide enough detail to support the conclusions in the report.

Recommendations:

Supervisory reviews of CRA PE reports and supporting workpapers are an essential control to ensure the reliability of the ratings assigned. Consequently, controls over the CRA examination process should be established and consistently applied. To improve the supervisory review process, we recommend that DCA:

- (5) Establish minimum guidelines for all Field Office Supervisors (FOSs) and Regional Office Review Examiners (REs) to follow in conducting their quality assurance reviews of PE reports.
- (6) Require that the FOSs and REs document their quality assurance reviews of PE reports.
- (7) Establish a requirement for minimum workpaper standards, including a requirement that the workpapers contain certain documents to support PE report conclusions.

CORPORATION COMMENTS AND OIG EVALUATION

On May 12, 2000, we provided a draft report to DCA for review and comment. We received a written response from management on June 21, 2000. However, the response did not include all elements required for a management decision on our recommendations. On July 14, 2000, subsequent to the issuance of our report and discussions with DCA staff and management, the Director, DCA, provided a revised written response to the draft report. The response is presented in Appendix III to this report.

The Director agreed to implement six of our seven recommendations. Action on these recommendations will be taken in conjunction with actions stemming from a DCA task force which is conducting a comprehensive review of DCA CRA performance evaluation reports. The

Director did not agree with our recommendation to include a separate section in each performance evaluation report on the results of community contacts. Instead, DCA will be considering alternative means to improve the presentation of data gleaned from community contacts.

Appendix IV presents management's planned actions on our recommendations and shows that there is a management decision for each of the seven recommendations.

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION CRITERIA

TYPE OF EVALUATION	PERFORMANCE CRITERIA
<p>LARGE BANK</p>	<p>LENDING TEST</p> <ul style="list-style-type: none"> <input type="checkbox"/> Volume of lending activity in the assessment area <input type="checkbox"/> Geographic distribution of loans, including proportion within an institution's assessment area and dispersion among geographies of different income levels <input type="checkbox"/> Distribution of loans based on borrowers of different income levels and small businesses and farms of different sizes <input type="checkbox"/> Community development loans <input type="checkbox"/> Innovative or flexible lending practices <p>INVESTMENT TEST</p> <ul style="list-style-type: none"> <input type="checkbox"/> Number and dollar amount of qualified investments <input type="checkbox"/> Innovativeness and complexity of qualified investments <input type="checkbox"/> Responsiveness to community development needs <input type="checkbox"/> Degree to which investments are not provided by private investors <p>SERVICE TEST</p> <ul style="list-style-type: none"> <input type="checkbox"/> Distribution of branches <input type="checkbox"/> Record of opening and closing branches <input type="checkbox"/> Availability and effectiveness of alternative systems for delivering retail bank services to low- and moderate-income people and geographies <input type="checkbox"/> Range of services provided and degree to which services meet the needs of the community <input type="checkbox"/> Extent of community development services provided <input type="checkbox"/> Innovativeness and responsiveness of community development services
<p>SMALL BANK³</p>	<p>LENDING TEST</p> <ul style="list-style-type: none"> <input type="checkbox"/> Loan-to-deposit ratio <input type="checkbox"/> Percentage of loans in the institution's assessment area <input type="checkbox"/> Geographic distribution of loans <input type="checkbox"/> Distribution of loans based on borrowers of different income levels and businesses and farms of different sizes <input type="checkbox"/> Action taken in response to CRA complaints

³ A small institution is defined as one that, as of December 31 of either of the prior two calendar years, had total assets of less than \$250 million and was either independent or an affiliate of a holding company that had total banking and thrift assets of less than \$1 billion.

DESCRIPTION OF AUDIT SAMPLE AND 1998 CRA EXAMINATION RATINGS

1998 CRA EXAMINATIONS			
FDIC-SUPERVISED BANKS	NUMBER		
As of January 1, 1998	6,099		
As of December 31, 1998	5,882		
CRA EXAMINATIONS STARTED JANUARY 1 – DECEMBER 31, 1998			
1,983			
1998 CRA RATINGS ASSIGNED	NUMBER	PERCENT	
Outstanding	438	22%	
Satisfactory	1512	76%	
Needs to Improve	30	2%	
Substantial Noncompliance	3	0%	
AUDIT SAMPLE			
BANK RATINGS	LARGE	SMALL	TOTALS
Outstanding	6	10	16
Satisfactory	16	19	35
Needs to Improve	3	3	6
Substantial Noncompliance	0	0	0
TOTALS:	25	32	57




Federal Deposit Insurance Corporation

550 17th Street NW, Washington, DC 20429

Division of Compliance and Consumer Affairs

July 14, 2000

TO: David H. Lowenstein, Assistant Inspector General
OIG Office of Audits

FROM: Stephen M. Cross, Director 
Division of Compliance and Consumer Affairs

SUBJECT: Response to Draft Report Entitled: *Audit of the DCA CRA Examination Process*

As you know, the Division of Compliance and Community Affairs (DCA) responded on June 21, 2000 to your draft report, *Audit of the Division of Compliance and Consumer Affairs Community Reinvestment Act Examination Process*. Earlier this week, Tim Burniston and I met with Steve Switzer, Vernon Davis, and Vijay Deshpande to discuss the report and the Division's response to it, among other matters. We appreciate this opportunity to clarify the DCA management position about the recommendations in your report.

The report makes seven recommendations pertaining to the CRA examination process. The Division agrees with six of the seven recommendations. With respect to recommendation 2, we agree with the OIG conclusion that we need to improve the communication of information obtained from community contacts. However, at present we believe it is best to incorporate that information throughout the PE report where relevant, rather than segregate that information into a separate section of the report. In fact, there was a great deal of discussion about this matter when the FFIEC agencies were developing the interagency CRA examination procedures and PE formats, and we jointly decided that our present approach was preferable.

DCA will implement specific actions on each of the six other recommendations in your report by June 30, 2001. Specifically, at my direction, DCA has initiated a task force to perform a comprehensive review of its CRA Performance Evaluations. The task force, part of DCA's enhancement to its quality assurance program, is performing a nationwide review of up to 400 PEs from all 8 DCA regions. The review will focus on a wide range of issues relating to both the examination and the PE, including those underlying the recommendations made in your report. Outcomes from this task force will include recommendations for improving:

- the guidance provided to examiners (recommendation 1)
- the incorporation of information and data gleaned from community contacts (recommendation 2)
- the policy with respect to community contacts (recommendation 3)
- the policy with respect to the scope of small business/small farm reviews (recommendation 4)
- the guidelines for quality assurance reviews of PE reports (recommendation 5)
- the documentation for quality assurance reviews of PE reports (recommendation 6), and
- the minimum workpaper standards (recommendation 7)

We will provide the OIG with specific actions addressing the recommendations in this report following the internal review of PE reports currently underway. We plan to complete this PE review and have initial training for all DCA examiners – that will include the issues raised in the OIG report – at our December 2000 training conference, with full implementation no later than June 30, 2001. We invite the

OIG to attend this session of the training conference and make a presentation on this audit or any others either completed or anticipated. Please let us know if you would like to participate.

If you have any questions, please feel free to contact me at (202) 942-3080 or Jim Deveney at (202) 942-3096.

APPENDIX IV MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid. Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report and subsequent discussions with management representatives.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	Improve the guidance provided to examiners for consistent examination procedures and reports.	June 30, 2001	Revised Guidance to Examiners	None	Yes
2	Improve the incorporation of information and data gleaned from community contacts.	June 30, 2001	Improved Performance Evaluation Reports	None	Yes
3	Improve the policy with respect to community contacts.	June 30, 2001	Revised Policy	None	Yes
4	Improve the policy with respect to the scope of small business/small farm reviews.	June 30, 2001	Revised Policy	None	Yes
5	Improve the guidelines for quality assurance reviews of performance evaluation reports.	June 30, 2001	Improved Guidelines	None	Yes
6	Improve the documentation for quality assurance reviews of performance evaluation reports.	June 30, 2001	Improved Documentation	None	Yes
7	Improve the minimum workpaper standards.	June 30, 2001	Improved Workpaper Standards	None	Yes