Office of Inspector General

July 2005
Report No. 05-027

Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Eligibility Process

Office of Audits

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Background and Purpose of Audit

The FDIC's Division of Supervision and Consumer Protection (DSC) is responsible for conducting streamlined safety and soundness examinations under the Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) examination guidelines. From May 1, 2002, through September 30, 2004, the FDIC conducted 2,290 MERIT examinations.

An FDIC Examiner-in-Charge (EIC) determines the eligibility of an institution for a safety and soundness examination under MERIT guidelines during the pre-examination planning phase by applying MERIT eligibility criteria to the FDIC's knowledge of an institution, its size, complexity, and risk profile.

The objective of this audit was to determine whether the FDIC's process for determining an institution's eligibility for an examination under MERIT guidelines adequately considers the appropriate risk factors.

Results of Audit

The FDIC's MERIT eligibility criteria and screening process for determining an institution's eligibility for examination under MERIT guidelines are adequate. The MERIT eligibility criteria include a range of appropriate banking risk indicators that should identify those institutions with a higher risk profile that do not qualify for a streamlined examination. Also, about 18 months after launching this streamlined examination program, the FDIC conducted an evaluation of the MERIT guidelines which resulted in expanding, strengthening, and revising the MERIT eligibility criteria. Further, for the examinations we reviewed, examiners adequately applied the FDIC's MERIT eligibility criteria and screening process performed during pre-examination planning to provide reasonable assurance that only low-risk institutions qualified for a MERIT examination.

However, we found that the 33 pre-examination planning (PEP) memoranda we reviewed did not always clearly reflect the decisions made about an institution's MERIT eligibility. Although MERIT guidance states that the PEP memorandum should include a comment addressing the use of MERIT guidelines, the FDIC has not updated its PEP memoranda guidance since September 2001 -- before MERIT guidelines went into effect. Additional information reflecting the MERIT eligibility decision would increase assurance that the MERIT criteria are adequately considered and that examination procedures are planned commensurate with the relevant existing and potential risks at an institution.

Recommendation and Management Response

The report includes two recommendations for updating and clarifying pre-examination planning guidance. FDIC management concurred with both recommendations and we consider its planned actions to be responsive.

MERIT Eligibility Screening Process

Step 1. Institution Size	Step 2. Capital Status	Step 3. Composite Rating at Last Two Exams	Step 4. Eligibility Criteria
$1 billion or less	Well Capitalized	1 or 2	• Stable management
			• No recent change in control
			• No significant adverse external factors
			• No de novo, niche, or banks identified on DSC's Quarterly Lending Alert (QLA)
			• No significant change in risk profile evident from offsite analysis or monitoring systems
			• Effective formal or informal loan grading systems
			• No significant new business lines
			• No component rating of 3, 4, or 5

Source: Regional Directors Memorandum 2004-001, dated January 27, 2004.

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TABLE OF CONTENTS

Federal Deposit Insurance Corporation
801 17th St., NW Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: July 29, 2005

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

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Eligibility Process*
(Report No. 05-027)

This report presents the results of our audit of the Federal Deposit Insurance Corporation (FDIC) Division of Supervision and Consumer Protection's (DSC) process to determine eligibility for a streamlined safety and soundness examination using the Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) examination guidelines (MERIT examination). The objective of this audit was to determine whether DSC's process for determining an institution's eligibility for a MERIT examination adequately considers the appropriate risk factors. Specifically, we reviewed the criteria, risk factors, and process that DSC uses in making a determination as to whether an institution is eligible for a MERIT examination. Appendix I of this report discusses our audit objective, scope, and methodology in detail.

BACKGROUND

Since 1997, DSC has conducted process improvement efforts that have changed its approach to examinations and supervision, including implementing a risk-focused examination process and streamlined MERIT examination procedures at banks with low-risk profiles.

Risk-focused Examination Process and MERIT Guidelines

On October 1, 1997, the FDIC, in conjunction with the Federal Reserve Board (FRB) and Conference of State Bank Supervisors (CSBS), began implementing a new risk-focused examination process designed to focus safety and soundness examinations on bank functions that pose the greatest risk exposure to the FDIC insurance funds. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of the bank, including the assessment of risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing resources on the bank's highest risks. The exercise of examiner judgment to determine the depth of review in each functional area is crucial to the success of the risk-focused supervisory process.

In 2000, DSC recognized the need to adjust to a changing banking industry and began a series of process redesign efforts to evaluate its own organization. The DSC's Process Redesign program focused on strategic changes in examination processes and economies in personnel and infrastructure. In 2001, Process Redesign I resulted in recommendations to streamline DSC's examination, supervision, and application review processes. One of the changes included streamlining the pre-examination process and loan reviews.

In 2002, Process Redesign II focused on the effectiveness and efficiency of examinations of 1 and 2 rated, well-capitalized banks with total assets of $250 million or less. Based on the low-risk profile of these institutions, DSC concluded that maximum use of risk-focused examination procedures was warranted and developed new target ranges for loan penetration coverage.[1] DSC implemented MERIT examination guidelines in April 2002. An interdivisional group (the MERIT Evaluation Team) subsequently evaluated the original MERIT examination program and, based on the team's conclusions, DSC expanded the MERIT guidelines in February 2004 to include institutions that are well capitalized with total assets of $1 billion or less and a 1 or 2 composite rating for the institution's two most recent examinations. Additional criteria for inclusion or exclusion of financial institutions in the MERIT guidelines are outlined in Appendix II.

From May 1, 2002 through September 30, 2004, the FDIC conducted 5,976 safety and soundness examinations, of which 2,290 were conducted as MERIT examinations.

Pre-examination Planning

According to DSC's *Risk Management Manual of Examination Policies*, thorough pre-examination planning is critical to the efficient completion of an examination. Pre-examination planning will determine if the MERIT guidelines can be used. It can also help determine staffing needs for MERIT examinations, including the number and expertise of personnel required. Finally, pre-examination planning can enhance the general orderliness and efficiency of an examination. The Examiner-in-Charge (EIC) is responsible for developing an examination plan that is commensurate with the level of risk in each functional area and for documenting this plan in a scope memorandum referred to as the Pre-Examination Planning (PEP) Memorandum. Pre-examination planning sets scope decisions in terms of work to be performed, areas to receive special attention, and decisions to limit procedures.

To provide EICs and examiners with a tool to focus on risk management and establish an appropriate examination scope, examination procedure modules were developed jointly by the FDIC and the FRB. Specifically, an examination procedure module, *Risk Scoping Activities,* was developed and issued in October 1997 and was updated in March 2005. This module identifies and lists several activities to be completed by examiners during the pre-examination planning process. This module helps the EIC determine the examination scope, allocate staff resources, and prepare a PEP memorandum.

[1] The loan penetration ratio is calculated by dividing the total dollar volume of nonhomogenous loans reviewed by the total dollar volume of nonhomogenous loans. Nonhomogenous loans may be broadly defined as loans that are commercial or agricultural in nature and that generally require individual loan review.

Additionally, DSC has issued guidance for the preparation of PEP memoranda in Regional Directors Memorandum 2001-037, dated September 12, 2001. This memorandum focused attention on preparing a PEP memorandum that conveys and documents the EIC's conclusions regarding the allocation of examination resources according to perceived risk. Memorandum 2001-037 also emphasized that the PEP process be more concise and that comments be prepared on an "exception only" basis, according to areas of higher-than-normal or lower-than-normal perceived risk.

RESULTS OF AUDIT

The FDIC's MERIT eligibility criteria and screening process for determining an institution's eligibility for examination under MERIT guidelines are adequate. The MERIT eligibility criteria include a range of appropriate banking risk indicators that should identify those institutions with a higher risk profile that do not qualify for a streamlined examination. Also, about 18 months after launching this streamlined examination program, the FDIC conducted an evaluation of the MERIT guidelines which resulted in expanding, strengthening, and revising the MERIT eligibility criteria. Further, for the examinations we reviewed, examiners adequately applied the FDIC's MERIT eligibility criteria and screening process performed during pre-examination planning to provide reasonable assurance that only low-risk institutions qualified for a MERIT examination.

However, the PEP memoranda that we reviewed did not always clearly reflect the decisions made about an institution's MERIT eligibility. Although MERIT guidance states that the PEP memorandum should include a comment addressing the use of MERIT guidelines, the FDIC has not updated its PEP memoranda guidance since September 2001, before MERIT guidelines went into effect. Additional information reflecting the MERIT eligibility decision would increase assurance that the MERIT criteria are adequately considered and that examination procedures are planned commensurate with the risks at an institution.

FINDING A: MERIT ELIGIBILITY CRITERIA AND SCREENING PROCESS

The MERIT examination guidelines were established to apply to banks that meet basic eligibility criteria, which includes having total assets of $1 billion or less, are well capitalized, and have satisfactory regulatory ratings defined as a 1 or 2 composite rating received at the last two safety and soundness examinations. We viewed the dollar threshold in total assets, capitalization requirement, and composite regulatory ratings as basic eligibility criteria. We viewed the remaining eight criteria in the MERIT guidelines as risk indicators that essentially screen out those institutions that are not regarded as being low risk institutions:

- stable management;
- no recent change in control;
- no significant adverse external factors;
- no de novo, niche, or banks identified on DSC's Quarterly Lending Alert (QLA);[2]
- no significant change in risk profile evident from offsite analysis or monitoring systems;
- effective formal or informal loan grading systems;
- no significant new business lines; and
- no component rating of 3, 4, or 5.

Banks meeting the criteria are then divided into two categories for the purpose of determining a range of nonhomogenous loan penetration ratios:

- Category 1 – Banks with an asset quality rating of 1 at the last examination (including state banking authority examinations accepted by the FDIC); and

- Category 2 – Banks with an asset quality rating of 2 at the last examination.

Category 1 banks have a target loan penetration of 15-25 percent, and Category 2 banks have a target loan penetration of 20-30 percent.

MERIT Eligibility Criteria – Eight Risk Indicators

We reviewed the eight MERIT risk indicators to understand how each correlated to the common risk categories or risk definitions used by banks and regulators. We also determined whether these risk indicators correlated to one or more of the CAMELS rating components established in the Uniform Financial Institutions Rating System (UFIRS) used by bank regulators to ensure that all financial institutions are evaluated in a comprehensive and uniform manner. CAMELS rating factors address the adequacy of **C**apital, the quality of **A**ssets, the capability of **M**anagement, the quality and level of **E**arnings, the adequacy of **L**iquidity, and the **S**ensitivity to market risk.

[2] The QLA is a DSC internal reporting mechanism for identifying those insured institutions engaged in lending activities that inherently pose an increased risk to the institution, including subprime lenders, payday lenders, and other high-risk lenders. The DSC regions report this information to DSC's Washington office quarterly.

According to The Financial Services Roundtable,[3] regulatory definitions for the various categories differ somewhat from those used by banks; however, regulatory agencies generally agree that banks face strategic, credit, market, liquidity, operational, compliance, legal, regulatory, and reputation risks. For example, the FDIC focuses on credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks when evaluating an institution's management. According to U.S. bank regulator examination manuals and a Basel Committee on Banking Supervision[4] publication entitled, *Core Principals for Effective Banking Supervision*, banking supervisors need to understand these key risks and be satisfied that banks are adequately measuring and managing them. We found that the eight MERIT risk indicators generally correlated to one or more of the common risk categories used by banks and regulators.

We also determined whether the eight MERIT risk indicators correlated to the CAMELS rating components used by bank regulators. We found that the eight MERIT risk indicators generally correlated to some aspect of one or more of the CAMELS rating components. It is important that the eight MERIT risk indicators correlate to one or more of the CAMELS rating components because the UFIRS that was adopted by the Federal Financial Institutions Examination Council (FFIEC) has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern.

We further concluded that in addition to adequately addressing existing risk in an institution, certain MERIT risk indicators were appropriate and forward-looking, that is, they acted as red flags to identify potential risks that might be present in an institution. Examples of forward-looking MERIT risk indicators include:

- banks identified on DSC's QLA,
- no significant changes in risk profile evident from off-site analysis or monitoring systems, and
- no significant new business lines.

FDIC Evaluated and Strengthened the Original MERIT Eligibility Criteria

In March 2002, the FDIC introduced the MERIT guidelines with the purpose of implementing streamlined examinations guidelines in well-rated banks with total assets of $250 million or less, while maintaining the quality and integrity of the examination process. After approximately 18 months, the MERIT Evaluation Team evaluated the MERIT examination program and recommended that the initial MERIT eligibility criteria be expanded and enhanced, including raising the total asset limit for MERIT eligibility from $250 million to $1 billion. The MERIT

[3] The Financial Services Roundtable promotes the business of banking and encourages the development of sound banking and financial policies and practices. Membership in The Financial Services Roundtable is reserved for the 125 largest banking and thrift companies in the United States. The roundtable sponsors independent research and analysis of issues relating to the future development of the nation's banking and financial system.

[4] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

Evaluation Team found that banks with $1 billion in assets or less had many characteristics similar to the $250 million-and-under banks and that FDIC's supervisory approach to these institutions was similar.

In January 2004, along with raising the MERIT threshold from $250 million in total assets to $1 billion, the FDIC made enhancements to the eligibility criteria. Specifically, the FDIC expanded and modified the MERIT procedures for all examinations commencing after January 31, 2004 as follows:

- "Well-Capitalized" banks having a 1 or 2 composite rating was changed to "Well-Capitalized" banks having a 1 or 2 composite rating for the two most recent examinations.

- The basis for selecting the target loan penetration ratio range was changed from the CAMELS composite rating to the asset quality component rating. In addition, this change was accompanied by a change from reviewing the last two examinations' composite rating to reviewing the last examination's asset quality rating.

- The subprime lender[5] exclusion was broadened to encompass all banks identified on DSC's QLA.

MERIT eligibility criteria need to be occasionally reviewed and updated because risks change quickly in the current U.S. banking environment. If the FDIC does not occasionally update the MERIT eligibility criteria, or whenever circumstances indicate a material change in the underlying assumptions about the associated risks, the FDIC risks initiating MERIT examinations without consistent consideration of new and emerging risk factors. This could result in MERIT examinations being conducted on institutions with high exposure to emerging risks or eliminating institutions from MERIT based on risks that may no longer be relevant. By revisiting the MERIT eligibility criteria, the FDIC's evaluation of the eligibility criteria ensures that they remain relevant and in a state of continual improvement. We viewed the FDIC's evaluation of the MERIT examination program as a practice that should continue, especially when circumstances indicate that material changes are occurring in the MERIT criteria's underlying risk assumptions.

MERIT Eligibility Screening Process

Thorough pre-examination planning is critical to the efficient completion of an examination. Pre-examination planning will determine whether MERIT guidelines can be used and will help set scope decisions in terms of work to be performed and areas to receive special attention.

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[5] The term subprime refers to the credit characteristics of borrowers who typically have weakened credit histories that include payment delinquencies, previous charge-offs, judgments, or bankruptcies. On January 31, 2001, the Federal banking regulators issued expanded guidance for the examination of subprime lending activities. The guidance applies to those institutions that deliberately target the subprime market as part of their business strategy and have an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital.

Table 1 summarizes a four-step screening process that an EIC uses during pre-examination planning to determine whether an institution qualifies for a safety and soundness examination under streamlined MERIT guidelines.

Table 1: MERIT Eligibility Screening Process

Step 1. Institution Size	**Step 2. Capital Status**	**Step 3. Composite Rating at Last Two Examinations**	**Step 4. Eligibility Criteria** (see Appendix III for a detailed description)
$1 billion or less	Well Capitalized	1 or 2	• Stable management
			• No recent change in control
			• No significant adverse external factors
			• No de novo, niche, or banks identified on DSC's QLA
			• No significant change in risk profile evident from offsite analysis or monitoring systems
			• Effective formal or informal loan grading systems
			• No significant new business lines
			• No component rating of 3, 4, or 5

Source: Regional Directors Memorandum 2004-001, *Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Guidelines,* dated January 27, 2004.

Our review of 33 PEP memoranda and associated examination data (Reports of Examination, DSC's Supervisory Tracking and Reporting Module data, and DSC's correspondence files) showed that the institutions that had been examined under MERIT guidelines met the MERIT eligibility criteria. In addition, we reviewed and analyzed Supervisory Tracking and Reporting Module data and applied the MERIT eligibility screening process to the 2,290 MERIT examinations FDIC conducted from April 2002 through September 2004. Based on the data available in the Supervisory Tracking and Reporting Module, we found no instances in which it appeared that an institution did not meet MERIT eligibility criteria.

FINDING B: PRE-EXAMINATION PROCESS AND GUIDANCE

The FDIC needs to update its PEP process and guidance to promote a uniform format and content for documenting the MERIT eligibility decision. Based on our review of the 33 PEP memoranda in our sample, we found that they did not always clearly reflect the eligibility decisions reached. As a result, there was limited assurance that the EIC had adequately considered all MERIT criteria in making the eligibility determination and scoping MERIT examinations.

Regional Directors Memoranda Addressing Pre-Examination Planning

Regional Directors Memorandum 2002-016, *Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Guidelines,* dated March 27, 2002, implemented the initial MERIT guidelines effective April 1, 2002. DSC expanded and modified the MERIT procedures as established in Regional Directors Memorandum 2004-001, *Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Guidelines,* dated January 27, 2004, and effective for all examinations commencing after January 31, 2004. Memoranda 2002-016 and 2004-001 contain the following guidance for EICs:

> As part of the pre-examination planning process, the EIC should utilize available resources (e.g., prior reports of examination; correspondence; UBPR [Uniform Bank Performance Report]; offsite monitoring tools; discussions with FOS [Field Office Supervisor], Case Manager, bank management and external/internal auditors; etc.) to determine if MERIT guidelines can be utilized. The Pre-Examination Planning Memorandum should include a comment addressing the use of MERIT guidelines.

The EIC determines the eligibility of an institution for a safety and soundness examination under MERIT guidelines by applying MERIT eligibility criteria to the FDIC's knowledge of the institution, its size, complexity, and risk profile. Once a MERIT examination commences, streamlined examination procedures are performed to determine whether any concerns are present that affect an institution's ability to identify, measure, control, or monitor risks. If such concerns are identified, the EIC contacts his/her Field Supervisor or Senior Examiner to discuss the concerns, decide whether the examination scope should continue as planned (MERIT) or be expanded as necessary. The MERIT guidelines are not intended to limit an examiner's ability to properly assess a bank's risk profile or to be a substitute for examiner judgment.

Regional Directors Memorandum 2001-037, *Revised Pre-examination Planning Memoranda*, dated September 12, 2001, states that the primary purpose of the PEP memorandum is to convey and document examiners' conclusions regarding allocation of examination resources according to perceived risk. Memorandum 2001-037 also states that DSC's Process Redesign initiative concluded that the PEP process should be streamlined and made more efficient by eliminating multiple layers of review. To facilitate efficiency, Memorandum 2001-037 revised the PEP documentation process to accomplish the following:

1. Require that PEP memoranda comments be prepared on an “exception only” basis, according to areas of higher-than-normal or lower-than-normal perceived risk.
2. Encourage brief, bullet[ed] comments, not necessarily of report quality.
3. Promote uniformity in both the format and content of the regions’ PEP memoranda.
4. Eliminate hours data.[6]
5. Include high-level performance ratios and financial data.
6. Require formal examiner contact with the Case Manager during preplanning, which will be documented in PEP memoranda.
7. Eliminate the need for regional office approval of PEP memoranda.
8. Define the deadline for submission of PEP memoranda to be the last business day prior to the examination start date.

These revisions were designed to reduce the time examiners and reviewers spend composing, editing, and reviewing PEP documents and result in more concise pre-examination planning documents consistent with the stated purpose of the PEP memorandum: to allocate examination resources according to perceived risk.

Documentation of MERIT Eligibility Decisions and Examination Scope

Our review of PEP memoranda from 33 examinations showed that the EIC’s comments addressing the use of MERIT guidelines do not always contain an explanation regarding the institution’s qualifications for a safety and soundness examination under MERIT guidelines. Such an explanation would provide assurance that the EIC adequately assessed not only the institution’s asset size, safety and soundness rating, and capital category, but also the eight other criteria that an institution must meet to be eligible for a MERIT examination. More information may be needed when the institution is not eligible for MERIT or if its eligibility status has changed since the prior examination.

We found brief comments in 14 PEP memoranda that indicated the reason an institution qualified and in some cases, the reason additional work would be conducted in a targeted area(s). Conversely, we found 19 PEP memoranda that either stated that MERIT guidelines would be used or mentioned some aspect of MERIT examination procedures that would be employed. These memoranda did not explain the basis on which the institution qualified for MERIT or whether the EIC intended to conduct the entire examination under MERIT guidelines or in certain functional areas even though the bank was ineligible for a MERIT examination. Examples of comments for each of the two categories are provided in Table 2 on the next page.

[6] Before the issuance of Memorandum 2001-037, PEP memoranda included a discussion regarding examination hours (budgeted hours, average hours, and previous hours).

Table 2: Summary of 33 PEP Memoranda Comments on the Use of MERIT Guidelines

MERIT Comments:	Memoranda Considered Adequate	Memoranda Needing Improvement
1 Memorandum explained the MERIT eligibility decision; that is, it explained why the bank qualified or did not qualify for MERIT. Or, in some cases, the Memorandum explained the bank's transition from Non-MERIT (NM) to MERIT (M) or M to NM. **Example 1, NM to M:** "The bank is "Well Capitalized" with a composite rating of "2" at the last two examinations and current total assets of $125 million. Despite being on the Growth Monitoring System (GMS), the bank is eligible for a MERIT examination. The growth is well managed and the bank meets all other criteria for conducting a MERIT examination." **Example 2, NM to M:** "The bank qualifies for MERIT, and it is anticipated that MERIT procedures will be used in all examination areas; however, the loan area will involve the use of some expanded procedures given the increased construction/development lending and previous examination criticisms, primarily related to credit administration. Additionally, examiner review of Bank Secrecy Act related policies and procedures will be increased over previous examinations and will include a review of the bank's compliance with Bank Secrecy Act regulations, the USA Patriot Act, and financial recordkeeping regulations. On-the-job fraud training may also result in some expanded procedures being performed on a limited basis. Some limited review of the Call Report will also occur due to the previous examination comments about errors." **Example 3, M to NM:** "S&S – MERIT examination procedures are not applicable and will not be used. MERIT is not applicable due to the "3" rated components and the ineffective loan grading system noted at the 2003 State examination."	14	
2. Memorandum mentioned that MERIT guidelines would be used, however, no explanation of the MERIT eligibility decision, why the bank qualified/did not qualify for MERIT. **Example 4, NM to M:** "This examination will be conducted using the outstanding MERIT procedures." **Example 5, NM to M:** "The loan penetration ratio will range between 20-30% based on merit examination guidelines."		19
	42.4%	**57.6%**

Source: OIG analysis of PEP Memoranda.

PEP Process Guidance Has Not Been Updated

The FDIC has not updated its September 2001 guidance for documenting the PEP process to reflect major changes in how a safety and soundness examination should be planned. The MERIT guidance defined risk-focused criteria and provided a framework for pre-planning safety and soundness examinations and risk-focusing examination procedures in institutions with low-risk profiles (see Appendix II for details). However, the current PEP memorandum format does not incorporate a uniform format and content for documenting the MERIT eligibility screening process and MERIT eligibility decision.

Furthermore, the PEP memorandum example attached to Memorandum 2001-037 contained instructions regarding the minimum information needed (see Appendix III). These instructions state, “Examiners **are not required** to comment on areas subject to regular examination procedures.”

The instructions within the Preliminary Risk Assessment section of the PEP memorandum are not clear regarding the extent of the work to be done (i.e., use of full examination procedures vs. MERIT guidelines vs. expansion of select procedures in targeted areas under MERIT guidelines). The PEP memorandum guidance predated the advent of MERIT guidelines; therefore, the instructions should be clarified regarding what constitutes “regular examination procedures” since implementation of the MERIT guidelines. We agree that areas subject to full examination procedures need not be discussed in PEP memoranda. However, to the extent that determinations are made to revise or eliminate examination coverage based on risk, the basis for these determinations should be discussed in the PEP memorandum.

Improved Documentation Increases Assurance that MERIT Eligibility Decision and Examination Scope are Commensurate With Institution Risk

Brief comments describing how the EIC determined that the institution was MERIT-eligible would support and assure that the decision to use MERIT guidelines was appropriate. This additional information would increase assurance that the MERIT criteria are adequately considered and that examination procedures are planned commensurate with relevant existing and potential risks that are present in an institution.

RECOMMENDATIONS

We recommend that the Director, DSC:

(1) Update the Regional Directors Memorandum entitled, *Pre-Examination Planning Memoranda*, to include instructions for incorporating MERIT eligibility decisions into the PEP memoranda.

(2) Clarify what constitutes “regular examination procedures” in the *Instructions* found under the Preliminary Risk Assessment section of the PEP memorandum.

CORPORATION COMMENTS AND OIG EVALUATION

On July 26, 2005, the Director, DSC, provided a written response to the draft report. The response is presented in its entirety in Appendix IV of this report. DSC concurred with both recommendations. A summary of the Director's comments on each recommendation follows, along with our evaluation of the response.

Recommendation 1: Update the Regional Directors Memorandum entitled, *Pre-Examination Planning Memoranda,* to include instructions for incorporating MERIT eligibility decisions into the PEP memoranda.

DSC's Director concurred with this recommendation, stating that DSC will provide clarification to examiners indicating that the PEP memoranda should discuss the basis of the decision to examine an institution under the MERIT guidelines. This clarification, via written memorandum, will be completed by March 31, 2006.

OIG Evaluation: This recommendation is resolved but will remain undispositioned and open for reporting purposes until we have determined that the agreed-to corrective action has been completed and is effective.

Recommendation 2: Clarify what constitutes "regular examination procedures" in the *Instructions* found under the Preliminary Risk Assessment section of the PEP memorandum.

DSC's Director concurred with the intent of this recommendation but offered an alternative corrective action. DSC noted that the PEP memorandum makes two different references to examination procedures, referring to both "standard" and "regular" procedures. DSC pointed out that the narrative section of the PEP memorandum refers to "standard examination procedures," which are defined in a footnote as the preparation of the Core Examination Documentation (ED) Analysis or similar procedures. However, the instructions in the Preliminary Risk Assessment section of the PEP memorandum example refer to "regular examination procedures." DSC agreed to amend the PEP memorandum example to "standard examination procedures" and indicated that doing so will provide more clarity and more consistency throughout the document.

OIG Evaluation: This recommendation is resolved but will remain undispositioned and open for reporting purposes until we have determined that the agreed-to corrective action has been completed and is effective.

Appendix V contains a summary of management's response to the recommendations and the status of the recommendations as of the date of this report.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of this audit was to determine whether DSC's process for determining an institution's eligibility for a MERIT examination adequately considers the appropriate risk factors. Specifically, we reviewed the criteria and risk factors that DSC uses in making a determination as to whether an institution is eligible for a MERIT examination.

Scope and Methodology

We performed our audit from November 2004 through April 2005 in accordance with generally accepted government auditing standards. To accomplish the audit objectives, we:

- reviewed DSC's MERIT policies and procedures related to risk-focused examination planning methodology, risk factors, and scoping;

- reviewed FRB, Office of the Comptroller of the Currency, and Office of Thrift Supervision policies and procedures pertaining to risk-focused examination planning methodologies and risk factors;

- reviewed and analyzed a judgmental sample of Pre-examination Planning (PEP) Memoranda prepared by FDIC EICs during the period April 2002 through September 2004, and reviewed and analyzed available electronic Supervisory Tracking and Reporting Module data to ensure that the 2290 MERIT examinations conducted during this period were eligible under the selection criteria available in the data;

- reviewed and analyzed Reports of Examination related to the examinations that evolved from our sampled PEP memoranda;

- accessed, reviewed, and analyzed information from the Supervisory Tracking and Reporting and Summary Analysis of Examination Reports (SAER)[7] modules of the FDIC's Virtual Supervisory Information On the Net system for the examinations related to the sampled PEP memoranda;

- interviewed or corresponded with DSC policymakers in Washington, D.C., regional office management, and field office management as needed; and

[7] The SAER provides a historical record of an institution, and includes comments that briefly summarize an examination's findings. In developing SAER comments, emphasis is placed on the CAMELS components and weaknesses identified in the report.

- reviewed DSC's assessment of the MERIT examination program, specifically the assessment used to justify expansion of MERIT to additional institutions. DSC's assessment led to recommendations for expansion of MERIT to additional financial institutions after January 31, 2004, as outlined in Transmittal 2004-001, *Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Guidelines,* dated January 27, 2004.

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

We used computer-based data from the Supervisory Tracking and Reporting Module to apply the MERIT criteria to the examinations conducted by FDIC from April 2002 through September 2004. We also used computer-based data as a supplemental source of information in conjunction with supporting documents and as background information in generating a universe of examinations from which to select our sample. Although we did not perform assessments of computer-based data, no discrepancies between computer-based data and supporting documentation came to our attention during the course of the audit. We did not find any MERIT performance measures in FDIC activities related to the Government Performance and Results Act. Our audit program did include steps for providing reasonable assurance of detecting fraud or illegal acts. We did not identify any illegal acts or abuse or potential areas susceptible to illegal acts or abuse. Additionally, we gained an understanding of relevant control activities related to MERIT examinations by examining DSC-applicable policies and procedures as presented in the *DSC's Risk Management Manual of Examination Policies* and Regional Directors Memoranda.

Pertinent Laws and Regulations

Section 10(d) of the Federal Deposit Insurance (FDI) Act requires that each appropriate federal banking and thrift agency conduct a full scope, on-site examination of federally insured depository institutions under its jurisdiction at least once during each 12-month period. The minimum requirements of a full-scope examination are defined as the procedures necessary to complete the mandatory pages of the uniform Report of Examination and evaluate all components of the CAMELS rating system. Our testing of MERIT examinations and FDIC's compliance with laws and regulations was limited to the aforementioned parts of section 10(d) of the FDI Act. Our review did not find any instances of FDIC noncompliance with pertinent laws and regulations.

Summary of Prior Audit Coverage

The Office of Inspector General completed three prior reviews of the FDIC's risk-focused examination process and one review of the process for tracking and evaluating the impact of the MERIT guidelines.

Audit Report No. 05-015, *DSC's Process for Tracking and Evaluating the Impact of the MERIT Guidelines*, was issued March 31, 2005. This audit focused on the adequacy of DSC's tracking and evaluation of the achievement of its goals for the MERIT guidelines. Specifically, the audit assessed the adequacy of processes, reports, and other data that DSC management used in monitoring MERIT examination coverage in financial institutions.

Audit Report No. 00-016, *Follow-up Audit of the Implementation of the Risk-Focused Examination Process*, was issued May 5, 2000 as a supplement to the Audit Report No. 98-086, *Audit of the Implementation of the Risk-Focused Examination Process*, which was issued November 5, 1998. These two audits focused primarily on the implementation of risk-focused examination procedures and workpaper and documentation uniformity. Audit Report No. 01-016, *Audit of DOS's Use of Expanded and Impact Examination Procedures in the Risk-Focused Examination Process*, issued March 30, 2001, focused on workpaper support for risk-focused examinations. The three reviews addressed risk-focused examination procedures but primarily focused on examination support and documentation.

MERIT PROGRAM GUIDELINES

Effective April 1, 2002, the FDIC implemented the MERIT program guidelines to assist examiners in risk-focusing examination procedures in institutions with low risk profiles. The FDIC developed the guidelines for examinations of 1 and 2 rated, "well-capitalized" banks with total assets of $250 million or less. DSC expanded and modified the MERIT procedures for all examinations commencing after January 31, 2004 as specified below:

- The total asset threshold for eligibility was increased from $250 million to $1 billion.
- The basis for selecting the target loan penetration ratio range was changed from the composite rating to the asset quality rating. In addition, this change was accompanied by a change from looking back at the last two examinations' composite rating to the last examination's asset quality rating.
- The subprime lender exclusion was broadened to encompass all banks identified on DSC's Quarterly Lending Alert (QLA).
- "Well-Capitalized" banks having a "1" or "2" composite rating was changed to "Well-Capitalized" banks having a "1" or "2" composite rating for the two most recent examinations that meet the additional criteria described herein are eligible for the MERIT guidelines.

Additional MERIT eligibility factors Memorandum 2004-001 follow:

- Stable Management - Banks that have management teams that have not exhibited significant changes in operating management or boards of directors since the prior examination.
- No Change in Control - Banks that have experienced a significant change in ownership or a change in control since the prior examination are ineligible for the MERIT guidelines.
- No Significant Adverse External Factors - Natural disasters or local and national adverse economic conditions could result in the exclusion of a bank from MERIT.
- No De Novo, Niche, or Banks identified on DSC's Quarterly Lending Alert. These banks are excluded from MERIT. De novo banks are institutions that have been insured for less than three years. A niche bank could be any specialized type of bank, such as a credit card or Internet bank. Currently, the QLA includes:
  - Institutions in which subprime loans represent 25 percent or more of Tier 1 capital;
  - Institutions in which high loan-to-value loans represent 25 percent or more of Tier 1 capital;
  - Institutions that, as a significant part of their business, make or purchase loans for sale or securitization and have those loans serviced and held off-premises by third parties or affiliates;
  - Institutions in which residual assets represent 25 percent or more of Tier 1 capital; and
  - Institutions directly or indirectly engaged in payday lending.

- No Significant Change in Risk Profile Evident from Off-Site Analysis or Monitoring Systems – The presence of a bank on the Growth Monitoring System (GMS), Statistical CAMELS Offsite Rating (SCOR), and Real Estate Stress Test (REST), etc., will not automatically exclude a bank from the program. However, adverse conclusions derived from off-site monitoring systems should make a bank ineligible for MERIT guidelines.

- Effective Loan Grading System – Banks that have adequate formal or informal loan grading processes appropriate to the size and complexity of the institution should be considered for MERIT guidelines. Small, rural banks may not have a formal loan review or grading system, but if management exercises appropriate risk selection and identifies credit quality concerns, such banks should be considered for the MERIT guidelines.

- No Significant New Business Lines – Banks that have entered significant new business lines since the prior examination are ineligible for the MERIT guidelines.

- No Component rating of “3,” “4,” or “5” – Banks with any component rated “3,” “4,” or “5” at the prior examination, or in subsequent rating changes, are ineligible for the MERIT guidelines.

Even though a bank does not meet the criteria to qualify for the MERIT guidelines, examiners are still encouraged to maximize the use of current risk-focused examination procedures in areas that pose minimal risk to the institution. Banks meeting the criteria are divided into two categories:

- Category 1 - Banks with an asset quality component rating of 1 at the last Examination.[8]
- Category 2 - Banks with an asset quality component rating of 2 at the last Examination.[9]

For examinations of Category 1 banks, the non-homogenous loan penetration ratio should generally range between 15 percent and 25 percent. For Category 2 banks, the loan penetration ratio should generally range between 20 percent and 30 percent. The EIC has the discretion to target a loan penetration ratio that may be above or below these ranges, with the Field Supervisor’s or Supervisory Examiner’s concurrence.

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[8] Includes state banking authority examinations accepted by the FDIC.
[9] Ibid.

APPENDIX III

SAMPLE PRE-EXAMINATION PLANNING MEMORANDUM

PRE-EXAMINATION PLANNING REPORT		
Name of Financial Institution:	**Location (City, State):**	**Certificate Number:**

Exam Date		
	As of:	
	Start:	
	Est. End:	
CM Name/Date of Contact:		

PRE-EXAMINATION PLANNING DATA AND RATIOS			
	Current Examination SCOR	**Prior Examination CAMELS**	**Prior Examination CAMELS**
Rating			
Total Assets			
Tier 1 Leverage Ratio			
Class/Total Cap+ALLL			
Hours			
	Current Quarter Ratios	**Year-end Ratios**	**Prior Year-end Ratios**
Asset Growth Rate			
Net Interest Margin			
Return on Avg. Assets			
Tot PD* / Gross Loans			
Loan Loss/Avg Tot Lns			
ALLL / Total Loans			
Net Non-Core Deposits			
Loans/Total Assets			
Non-int Exp/Avg Assets			

*****All past-due loans plus non-accrual divided by gross loans.

IRRSA (Pass/Fail):

RE Stress Test Score (if applicable):

PRE-EXAMINATION PLANNING REPORT		
Name of Financial Institution:	**Location (City, State):**	**Certificate Number:**
PRELIMINARY RISK ASSESSMENT		
Instructions: Comment on any targeted risk areas that require additional examination resources or low risk areas that will be subject to a limited review during the examination. Examiners ***are not required*** *to comment on areas subject to regular examination procedures. Examiners are required to briefly discuss loan penetration strategies and summarize discussions held with management. Examiners should discuss staffing only if estimated hours are expected to differ substantially from budgeted hours, or if other concerns exist. Bullet comments are encouraged. Each examiner is expected to contact the institution case manager for input prior to completing this memorandum. The PEP should be submitted to the FOS for approval on the last business day prior to the start of the examination. A copy of the PEP should be forwarded to the Case Manager (CM).*		

Summary of Discussion with Management and Summary of Discussion with CM

Targeted Risk Areas (include CAMELS if applicable, specialty areas, IRC/audit, etc.)

Low Risk Areas Subject to Limited Review (include a brief explanation of why area is considered low risk)

Loan Scope

Staffing Discussion

Supervisory Action (if applicable)

Documentation Methodology

FOS Approval :		**Date:**

2

CORPORATION COMMENTS

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

Division of Supervision and Consumer Protection

July 26, 2005

TO: Russell A Rau
Assistant Inspector General for Audits

FROM: Michael J. Zamorski
Director

[Electronically produced version;
original signed by Michael J. Zamorski]

SUBJECT: Draft Report Entitled, *"Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) Eligibility Process"* (Assignment Number 2005-007)

The Division of Supervision and Consumer Protection (DSC) appreciates the opportunity to respond to this Draft Report prepared by the FDIC's Office of Inspector General (OIG). We have reviewed the results of this audit, and we are gratified with your conclusion that DSC'S eligibility criteria and screening processes are adequate for risk-scoping examinations for our lowest-risk institutions under MERIT guidelines. Further, your testing confirmed that "examiners adequately applied the FDIC's MERIT eligibility criteria and screening process performed during pre-examination planning to provide reasonable assurance that only low-risk institutions qualified for a MERIT examination."

The Draft Report concludes with two recommendations for enhancement to existing guidance. The recommendations are listed below with DSC's responses and planned actions.

OIG Recommendation:

(1) Update MERIT guidance on how to prepare Pre-examination planning (PEP) memoranda to include instructions for incorporating MERIT eligibility decisions.

FDIC Response:

DSC concurs with this recommendation. We will provide clarification to examiners indicating that the PEP memoranda should include a discussion as to the reason for inclusion of the institution to be examined under the MERIT guidelines. This clarification, via written memorandum, will be completed by March 31, 2006.

OIG Recommendation:

(2) Clarify what constitutes "regular examination procedures" in the PEP memorandum.

FDIC Response:

DSC concurs with the intent of this recommendation, and offers the following alternative suggestion. We note that there are two references to examination procedures in the PEP memorandum—standard and regular. In the narrative section of the PEP memorandum instruction it refers to "standard examination procedures," which are defined in the footnote as the preparation of the Core Examination Documentation (ED) Analysis or similar procedures. However, in the PEP memorandum example under *Preliminary Risk Assessment* it refers to "regular examination procedures." DSC agrees to amend the PEP memorandum example to "standard examination procedures", thus providing more clarity and more consistency throughout the document through the use of well-defined terminology. This action will be completed by March 31, 2006.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Dispositioned:[b] Yes or No	Open or Closed[c]
1	DSC concurred with this recommendation. DSC will provide clarification to examiners indicating that the PEP memoranda should include the reason for examining an institution under the MERIT guidelines. This clarification will be provided in a written memorandum.	March 31, 2006	None	Yes	No	Open
2	DSC concurred with the intent of this recommendation, but offered an alternative corrective action. DSC noted that the PEP memorandum makes two different references to examination procedures—"standard" and "regular" procedures. The narrative section of the PEP memorandum refers to "standard examination procedures" with an explanatory footnote and the example in the PEP memorandum refers to "regular examination procedures." DSC will amend the PEP memorandum example to "standard examination procedures" and indicated that doing so will provide more clarity and more consistency throughout the document.	March 31, 2006	None	Yes	No	Open

[a] 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.

[b] 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.

[c] Once the OIG dispositions the recommendation, it can then be closed.