RATIONALE OF BANK EXAMINATIONS

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

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

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

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

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

CONDUCT OF EXAMINATIONS

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

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

Prohibition Against Political Communication

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

THE UNIFORM FINANCIAL INSTITUTIONS RATING SYSTEM

Introduction

The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979. In December 1996, the FFIEC updated the UFIRS. The revised system was effective January 1, 1997. Over the years, the UFIRS 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. A number of changes occurred in the banking industry and in the Federal supervisory agencies' policies and procedures that prompted a review and revision of the 1979 rating system. The 1996 revisions to UFIRS include the addition of a sixth component addressing sensitivity to market risk, the explicit reference to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating descriptions.

The UFIRS takes into consideration certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies

endeavor to ensure that all financial institutions are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS also serves as a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system assists Congress in following safety and soundness trends and in assessing the aggregate strength and soundness of the financial industry. As such, the UFIRS assists the agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system.

Overview

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and, therefore, the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Foreign Branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include: Compliance, Community Reinvestment, Government Security Dealers, Information Technology (IT), Municipal Security Dealers, Transfer Agent, and Trust.

The following two sections contain the composite rating definitions and the descriptions and the definitions for the six component ratings.

Composite Ratings

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, liquidity adequacy, and sensitivity to market risk. The composite ratings are defined as follows:

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4

Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

Component Ratings

Each of the component rating descriptions is divided into three sections: an introductory paragraph; a list of the principal evaluation factors that relate to that component; and a brief description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The listing of evaluation factors for each component rating is in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially

adverse consequences that these risks may have on the institution's capital.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Ratings

1 A rating of 1 indicates a strong capital level relative to the institution’s risk profile.

2 A rating of 2 indicates a satisfactory capital level relative to the financial institution’s risk profile.

3 A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4 A rating of 4 indicates a deficient level of capital. In light of the institution’s risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5 A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the Allowance for Loan and Lease Losses (ALLL)and weigh the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves.
- The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.
- The diversification and quality of the loan and investment portfolios.
- The extent of securities underwriting activities and exposure to counter-parties in trading activities.
- The existence of asset concentrations.
- The adequacy of loan and investment policies, procedures, and practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- The adequacy of internal controls and management information systems.
- The volume and nature of credit documentation exceptions.

Ratings

1 A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management’s abilities. Asset quality in such institutions is of minimal supervisory concern.

2 A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3 A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

4 A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5 A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.
- Compliance with laws and regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Ratings

1 A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2 A rating of 2 indicates satisfactory management and

board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3 A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4 A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5 A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the ALLL, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability.
- The ability to provide for adequate capital through retained earnings.
- The quality and sources of earnings.
- The level of expenses in relation to operations.
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general.
- The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts.
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Ratings

1 A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2 A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3 A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4 A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5 A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on- and off-balance sheet.
- The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pools of assets.
- The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Ratings

1 A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2 A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

3 A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

4 A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5 A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to: management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For some institutions, trading activities are a major source of market risk.

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices.
- The ability of management to identify, measure, monitor,

and control exposure to market risk given the institution's size, complexity, and risk profile.

- The nature and complexity of interest rate risk exposure arising from nontrading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Ratings

1 A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2 A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3 A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4 A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5 A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

Disclosure of Ratings

It is the FDIC's view that disclosure of the CAMELS component and composite ratings to bank management is appropriate. The broad range of financial products offered through the financial services industry magnifies the importance of sound risk management policies and procedures. In this environment, the examination process is incomplete if it focuses solely on the institution's current financial condition, and fails to assess its ability to identify and adapt to changing economic, competitive, and other factors. Disclosure of the component and composite ratings encourages a more complete and open discussion of examination findings and recommendations, and therefore provides management with useful information to assist in making risk management procedures more effective.

Additionally, open discussion of the CAMELS component ratings provides institutions with a better understanding of how ratings are derived, and enables management to better address any weaknesses in specific areas.

Discussions with Management

The Examiner-in-Charge (EIC) should discuss the recommended component and composite ratings with senior management, and when appropriate the board of directors, within as close proximity to the conclusion of the examination as possible. Examiners should clearly explain that the ratings are tentative and subject to final approval by the Regional Director.

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

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

Finally, management should be reminded that the composite and component ratings, whether disclosed verbally or in the written report of examination, are subject to the

confidentiality rules imposed by Part 309 of the FDIC's Rules and Regulations.

EXAMINATION FREQUENCY

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

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

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

Alternate Examinations

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

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

Specialty Examination Intervals

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

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

When the State supervisory authority has examination responsibility for the safety and soundness examination of an institution, it will not be the responsibility of the region to

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

Insured Branches of Foreign Banks

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

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

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

EXAMINATION TYPES

Risk Focused Supervision

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

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

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

Full Scope Examinations

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 (Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) rating system. The completion of additional steps and pages may often be appropriate.

Maximum Efficiency, Risk-Focused, Institution Targeted (MERIT) Examination Guidelines

The MERIT examination guidelines were originally established in April 2002 and applied to banks that met basic eligibility criteria, which included having total assets of $250 million or less and satisfactory regulatory ratings. In February 2004, the MERIT program was expanded to include "well-rated" banks with total assets of $1 billion or less. These guidelines continue to emphasize maximum use of risk-focused examination procedures and establish target ranges for loan penetration coverage. Additionally, these guidelines reemphasize existing risk-focused examination procedures as well as examiner judgment to properly assess a financial institution's risk profile.

The expanded MERIT guidelines apply to institutions which are Well capitalized with total assets of $1 billion or less, and a 1 or 2 composite rating for the two most recent examinations, that also meet the following criteria:

- 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 off-site analysis or monitoring systems
- Effective formal or informal loan grading systems
- No significant new business lines
- 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 non-homogenous 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% and Category 2 have a target loan penetration of 20-30%.

Limited Scope Examinations and Visitations

The terms "limited scope examination" and "visitation" are interchangeable and may be defined as any examination that does not meet the minimum requirements of a full-scope examination. Since limited scope examinations and visitations are not full-scope examinations, they do not satisfy the requirements of Section 10(d) of the FDI Act. Limited scope examinations and visitations have a flexible format and may be used to: determine changes in an institution's risk profile; monitor compliance with a corrective program; comply with SCOR follow-up requirements and to investigate adverse or unusual situations; determine progress in correcting deficiencies noted at the previous examination; act as an investigative and supervisory tool; and comply with schedules described under Other Situations below.

Limited scope examinations and visitations may address the overall condition of the institution, including material changes since the previous examination and areas that exhibit more than normal risk. Depending on the focus of the scope and the purpose of the examination or visitation, examiners can assign composite ratings, as well as component ratings for areas that were sufficiently reviewed. Component ratings that were not reviewed should be carried forward from the previous examination.

Completion of the standard examination report form is not required, although appropriate report pages may be included if considered necessary to clarify a finding or recommendation. Results should generally be conveyed in a memorandum from the EIC to the Regional Director. If the examination or visitation results are to be sent to the institution, they can be in whatever form (letter or other suitable format) is considered appropriate.

Other Situations

In addition to the preceding instructions, examinations should be performed in the following situations:

Newly Chartered and Insured Institutions

If the institution is a subsidiary of a multi-bank holding company that is in satisfactory condition, the normal examination cycle should be followed; otherwise, a limited scope examination should be conducted within the first six months of operation, and a full-scope examination within the first twelve months of operation. Subsequent to the first examination and through the third year of operation, at least one examination should be performed each year. Extended examination intervals should not be applied in the first three years of operation. Subsequent to the initial full-scope examination, examinations may be alternated with the State supervisory authority if circumstances permit.

Institutions Converting to Insured Nonmember Status

A full-scope examination should be conducted within twelve months of the last examination prior to conversion for national, state member, and thrift institutions. For noninsured institutions converting to insured status, a full-scope examination should be conducted within twelve months of the FDIC entrance examination. A limited scope examination or visitation should be considered within three months of conversion, especially in banks that have not had an FDIC entrance examination.

Change of Ownership Control

If the FDIC's knowledge of the new ownership reflects satisfactory financial and management performance, standard examination intervals should apply. If new ownership is unknown, a limited scope examination should be conducted within the first six months of the change of ownership control, and a full-scope examination should be conducted within twelve months after the change. Thereafter, standard examination intervals apply.

Institutions that Received FDIC Assistance, or Been Involved in Purchase and Assumption or Deposit Transfer Transactions

Acquiring institutions with total assets in excess of ten times the deposits acquired, which are rated composite 2 or better, and which have an acceptable SCOR DIFF score are exempt from the following requirements. State nonmember institutions: a visitation or limited scope examination should

be conducted within 30 days of the transaction date to determine how funds from the FDIC are being used and whether the bank is in accordance with any applicable assistance agreement. A second visitation or limited scope examination should be conducted within six months of the transaction. A full-scope examination should be conducted within twelve months of the transaction. Thereafter, standard examination frequency schedules apply. A cooperative program should be established with the appropriate Federal agency for national, state member, and thrift institutions, to ensure that all institutions receiving FDIC funds are properly monitored and that the FDIC Regional Director is informed of important developments.

COORDINATION WITH OTHER AGENCIES

Coordination with State Authorities

Every effort should be made to coordinate examination schedules with State authorities to take advantage of State resources, to minimize duplications of effort, and to lessen business disruptions to the institutions. A representative of the Regional Office should meet with representatives from each State banking authority to determine examination responsibilities for the upcoming year. Responsibilities may be defined in broad categories by rating, size and location of institutions, or may be done by specific institution as deemed appropriate. Such agreements should contain enough flexibility to allow either party to alter schedules with minimal notice. While State examination requirements should be considered in the coordination process, statutory requirements should not be the determining factor in the final agreement.

Coordination of Bank Holding Company Inspections and Subsidiary Institution Examinations

Examinations of the subsidiaries of holding company organizations with consolidated assets over $10 billion, and those banking organizations (generally, with assets in excess of $1 billion) that exhibit financial weakness, should be coordinated with other Federal agencies.

Examinations and inspections of insured subsidiary banks and bank holding companies that do not meet the foregoing criteria should be coordinated to the extent practical and where resources permit. Regional Directors (or designees) should meet periodically with representatives from other Federal agencies to develop coordinated schedules that will maximize the use of examination resources and enhance the efficiency of bank and bank holding company examinations. The coordination of examinations should focus on the use of common financial statement dates, where possible, and allow for joint discussions of examination findings with management. However, absolute concurrence, common "As of" dates, or simultaneous starting dates are not required. Appropriate State regulatory agencies should also be kept informed and encouraged to participate in the coordinated Federal efforts affecting state banks.

Examinations of nonbank affiliates may be conducted at the discretion of the Regional Director, but independent examinations of holding companies supervised by the Federal Reserve may not be conducted without prior approval of the Washington Office.

Supervision of Interstate Banking Organizations and Chain Banks

A coordinated supervisory strategy for interstate banking organizations (both intra- and inter-regional) should be developed. The supervisory strategy developed should combine traditional supervision of individual units with an appropriate top-down approach to assess risk and to monitor and coordinate supervisory actions. For these organizations, the Regional Director has discretion to omit, delay or modify existing examination frequency policies if: the financial condition of the holding company and lead bank is considered satisfactory; the condition of the subsidiary units is believed to be satisfactory; control over all insured banks in the organization is effectively centralized; and, management is favorably regarded.

Regional Directors are responsible for: (a) designating a lead Region to design an appropriate supervisory strategy for interstate banking organizations; and (b) ensuring pertinent information is conveyed in a timely manner to other DSC Regions and to appropriate Federal and State agencies.

It is the policy of the Division to monitor and supervise banks that are part of a chain banking organization in a manner that fully considers the financial impact of the consolidated chain on the individual institutions within that chain. Regional Directors are responsible for maintaining a record system for chain banking organizations and for developing an overall supervisory strategy for those organizations.

SCHEDULING GUIDELINES

Periodic on-site examinations are critical to the supervisory process and are an integral part of the examination program. Diversified risks in the industry and the volatile performance and financial condition of individual institutions necessitate emphasis on more frequent and less structured supervision.

Investigations, phone calls, limited scope examinations, correspondence and other forms of customized contact should be made as necessary. The purpose is to identify and obtain corrections in an institution's policies and procedures before serious financial problems develop.

Pre-examination activities should include efforts to determine the activities engaged in and the condition of nonbank subsidiaries. If not determinable in advance, this should be conducted early in the examination in order to assess the necessity of and depth of examination of subsidiaries.

The success of this effort depends largely on the effectiveness of assignment scheduling and preordination. Examiner resources should be allocated and directed based on the best information available as to potential problems without over emphasizing the mere passage of time.

Anticipatory Supervision

To effectively prevent serious problems in an institution, the conditions and circumstances that may lead to problems must be identified and corrected early. Corrective action should be taken immediately upon identifying excessive risk taking. History has taught that when corrective action is not taken until conditions have deteriorated; it is often too late to avoid failure. Moral suasion and informal agreements are normally sufficient where the unacceptable risk-taking is identified early, but formal action must be considered, even when an institution is rated 1 or 2, if circumstances warrant.

A prospective supervisory approach, entailing criticism of policies and practices before unsafe and unsound conditions actually develop calls for serious thought and studied reaction by examiners. Critical comments must be well-supported and based on logic, prudent banking standards, and the potential for harm. In questionable circumstances where formal action is a possibility, examiners should consult with the Regional Office while the examination is in progress regarding the material needed to support a potential action.

Scheduling Process

A goal of examinations of 1 and 2-rated institutions is to correct weaknesses before they cause serious difficulties and become a financial risk to the FDIC. Therefore, it is far more important to examine, or otherwise supervise, a bank if there is some reason to suspect a problem than if the bank merely has not been examined in a specified period of time. Moreover, a formal examination may not be the most efficient use of resources in investigating the risk potential a bank may present. The objective is to assess the problem and, if necessary, devise a solution in the quickest, most efficient manner possible. Frequently, a telephone call or brief on-site visit may suffice. Sometimes such preliminary efforts will indicate that a full-scope examination is appropriate.

In order for all available information to be considered, it is critical that the Field Office Supervisor and other appropriate personnel be aware of and have access to the scheduling process. Regional Directors should ensure that copies of relevant correspondence and other pertinent information are made available. Procedures should ensure that information that may affect scheduling decisions is documented and made available to the involved personnel. Individuals doing scheduling must review and consider this information.

Because of the variety of sources and forms of relevant information available, it is not possible to design a uniform system of information gathering and reporting. However, the list below includes some information that may come to the FDIC's attention and have an influence in prioritizing assignments. Some of these items, such as involvement in FDIC assistance transactions, have supervisory schedules specified in our policy. Others are merely information that, in and of themselves, may or may not raise a concern depending on what else is known about the bank. However, these or similar items may give a signal that requires further follow-up. Such clues should not be ignored. The list, while not all inclusive, indicates a need for supervision to be anticipatory and provides a reminder of some of the common sources of information that may warrant consideration when scheduling.

Information to Consider in Scheduling Examinations

Effective bank supervision entails the continual assimilation of information from numerous sources, both within and outside the FDIC. The appropriate response, if any, depends on the circumstances, supervisory action already underway, what is known about the institution, and what can be learned from follow-up procedures. In some instances, the information serves as a "red flag," leading to an immediate examination. In less severe situations, the information is retained and factored into the process of scheduling future examinations. It is possible that a given piece of information can be derived from more than one source. Some of the items listed below could be included under more than one source.

Offsite Analysis and Monitoring

- SCOR Monitoring System
- Comprehensive Analytical Reports/Financial Interim Reports
- Growth Monitoring System

- UBPR Analysis

Other:

- Loss for the year or an interim period
- Rapid growth in assets or deposits
- Significant change in asset composition
- Significant change in liability composition
- Use of brokered funds
- Excessive dividends relative to earnings
- Excessive bond trading
- Other ratios or numbers that are unusual or have changed dramatically
- Unusually high Return on Assets (ROA)

Applications, Notices or Other Bank Provided Data

- Change of control
- Merger
- Acquisition or establishment of a new subsidiary
- Acquiring party in a FDIC arranged transaction
- Change in external auditor
- Exercise of a new power or a new profit center
- Newly insured institution
- Affiliation with a 3-, 4- or 5- rated institution or holding company
- Cancellation of blanket bond insurance
- Large defalcation
- Review of CPA audit reports
- Large pay down or payoff of previously classified loans

Known Characteristics

- Excessive salaries
- Failure to pay competitive salaries
- Compensation linked to future performance such as income, loan volume or deposit growth
- Infighting involving senior bank officers and/or directors
- Significant litigation against the institution or insiders
- Operating at the margin of laws and regulations
- Management believed to be less than trustworthy
- Self-serving management
- Dominating management
- Inexperienced management
- Substantial outside business interests of a key officer
- Conducting business with questionable firms such as certain bond dealers
- Lack of diversity in nature of business or other unique business strategy

Examinations of Other Banks

- Hiring of a dismissed, unethical, or marginal officer
- Refinancing poor quality loans
- Improper handling of correspondent bank accounts
- Advertising above market interest rates
- Undercutting on price and credit quality to increase market share of loans
- Large blocks of stock in the institution pledged as collateral
- Increased or unusual loan participations among affiliated or closely held institutions
- Banker with past due loans at another institution

Other Bank Regulators

- Improper handling of correspondent bank accounts
- Increased or unusual loan participations among affiliated or closely held institutions
- Large blocks of stock pledged as collateral
- Affiliation with a 3-, 4- or 5-rated institution or holding company
- Large defalcation
- Banker with past due loans at another institution
- Loans classified at other institutions

Media

- New chief executive officer or chief lending officer
- Adverse publicity
- Loss for the year or an interim period
- Adverse economic event in the community
- Natural disaster such as a flood, fire or earthquake
- Large defalcation
- Large financial commitment as sponsor or lead bank in a major project or development
- Banker death or disappearance
- Announcement of major new activity or department

Rumors/Observations/Other

- Change in external auditor
- High or sudden employee turnover
- Significant litigation against the institution or insiders
- Unusual activity in stock of the institution (price movement up or down or heavy trading volume)
- Institution advertising above market rates
- Significant change in the composition of assets or liabilities
- Questionable loans being booked
- Institution dealing with borrowers of questionable character
- Confidential or anonymous tips

GUIDELINES FOR RELYING ON STATE EXAMINATIONS

Section 349 of the Riegle Community Development and Regulatory Improvement Act of 1994 requires the FFIEC to issue guidelines establishing standards for the purpose of determining the acceptability of State Reports of Examination under Section 10(d)(3) of the FDI Act. Under Section 10(d)(3), a Federal banking agency may conduct an annual, on-site examination of an insured depository institution in alternate 12 (or 18) month periods if the agency determines that a State examination conducted during the intervening period is adequate. The standards issued by the FFIEC are to be used at the discretion of the appropriate Federal banking agency.

The supervisory divisions of the FDIC, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision (Federal banking agencies) responsible for the examination of state-chartered, insured depository institutions, and the branches and agencies of foreign banks that have been chartered by the states have a long history of coordinating with the State banking departments in fulfilling a mutual goal of promoting a safe and sound banking system. It is recognized that this close cooperation between the Federal and State regulators promotes efficiency in the examination process, reduces the regulatory burden on state-chartered, insured depository institutions, and improves the supervisory process.

The Federal and State banking agencies have worked together, to varying degrees, in the following areas:

- Conducting alternate, joint and concurrent safety and soundness examinations of insured depository institutions and of the branches and agencies of foreign banks that have been chartered by the states.
- Processing safety and soundness examination reports and applications on a timely basis.
- Using common examination report and application forms.
- Developing and issuing informal (e.g., board resolutions, memoranda of understanding or other similar agreements) and formal enforcement actions.
- Exchanging supervisory information.
- Offering Federal agency training programs to State examiners.
- Providing access to the Federal agency data bases.

The FDIC intends to continue these cooperative efforts to the maximum extent possible. It is recognized, however, that the adequacy of State budgeting, examiner staffing, and training are important factors to enhancing Federal and State coordination. The FDIC has entered into formal and informal arrangements or working agreements with most State banking departments. These working agreements or informal arrangements generally address the following areas:

- The number of state-chartered, insured institutions to be examined on an alternating basis by the State banking department and by the FDIC.
- The frequency of safety and soundness examinations.
- The type of examinations to be conducted (independent, joint, or concurrent) by each agency.
- The pre-examination procedures to be performed.
- The responsibilities of each agency for processing reports of examination.
- The responsibilities of each agency for conducting specialty examinations (compliance, IT, trust, etc.).
- The procedures for coordinating informal and formal enforcement actions.
- The procedures for processing joint applications.
- The procedures for sharing supervisory information.

These working agreements or informal arrangements are structured to permit both Federal and State agencies the flexibility to conduct an independent examination subject only to notification to the other party. Generally, only institutions rated 1 or 2 are examined on an alternating basis allowing for a reasonable interval between examinations.

A hallmark of a successful program has been the flexibility to tailor cooperation to the particulars of each state and to the specifics of individual banks within a state, plus the reality of changing circumstances at both the Federal and State levels. The FFIEC guidelines strive to maintain that flexibility.

The FDIC will accept and rely on State reports of examination in all cases in which it is determined that State examinations enable the FDIC to effectively carry out its supervisory responsibilities. The following criteria may be considered, in whole or in part, when determining the acceptability of a State report of examination under Section 10(d) of the FDI Act:

- The completeness of the State examination report. The State report of examination of a state-chartered, insured depository institution or a state-chartered branch or agency of a foreign bank should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the UFIRS used for insured depository institutions and commonly referred to as the CAMELS rating system or the ROCA rating system used for branches and agencies of foreign banks.
- The adequacy of documentation maintained routinely by State examiners to support observations made in

examination reports.

- The ability over time of a State banking department to achieve examination objectives. At a minimum, the FDIC will consider the adequacy of State budgeting, examiner staffing and training, and the overall review and follow-up examination process of a State banking department. Accreditation of a State banking department by the Conference of State Bank Supervisors is among the factors that also will be considered.
- The adequacy of any formal or informal arrangement or working agreement between a State banking department and the FDIC.

The FDIC, as part of its routine review of State examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the above general criteria. The FDIC retains the option in cases in which a State examination report appears insufficient or the condition of an insured institution, as indicated in the examination report or other sources, appears to be seriously deteriorating, to conduct a follow-up examination.

For institutions with a deteriorating condition, or ones for which offsite monitoring has indicated certain areas of concern such as unexplained rapid growth, the Regional Director may decide that the FDIC should take an active role in the pre-planning process prior to a State examination so that the examination can address the areas of concern. And, if necessary, the FDIC can join the examination if the appropriate cooperative examination program permits such action.

The FDIC and State banking departments will share, discuss and work to resolve any problems or concerns regarding the acceptability of each other's work or the operation of these guidelines and the alternating examination program, as well as other issues of mutual interest.

PRE-EXAMINATION ACTIVITIES

Thorough pre-examination planning is critical to the efficient completion of an examination. Pre-examination planning will determine if MERIT guidelines can be used and will help set scope decisions in terms of work to be performed and areas to receive special attention. It can also help determine staffing needs in regards to the number and expertise of personnel required. Finally, it can enhance the general orderliness and efficiency of an examination.

Part of the pre-planning process should also address the need for, or extent of, branch examinations. It is the FDIC's practice to examine the various offices of a branch banking system on an as-needed basis only. Such decisions are within the province of the Regional Director or may be delegated by the Regional Director to the Field Supervisor or EIC of a particular examination.

As a general rule, bankers should be given at least two weeks notice of an upcoming safety and soundness examination in order to provide them with enough time to complete pre-examination requests. A shorter period is permissible if the institution is not unduly burdened or if a shorter period is occasionally needed due to planning requirements. Exceptions to this general policy may include problem institutions, situations where management and ownership of the institution are identical, or in situations where conditions are deteriorating rapidly.

Examiners should make every effort to conduct as many pre-, post- and other examination procedures as reasonably possible off-site in order to minimize disruptions to an institution’s normal business activities. Additionally, examiners should be mindful of an institution’s space and personnel limitations and schedule the number of examiners working on bank premises accordingly.

An examination procedures module titled *Risk Scoping Activities* is included in the Examination Documentation Modules on the Examiner Reference CD. This module identifies and lists several activities to be completed by examiners during the pre-examination process. Refer to this module for additional guidance.

EXAMINER MEETINGS WITH BANK MANAGEMENT

Ongoing communication between the examination staff and bank management is a critical element of effective bank supervision. Open communication helps to ensure that examination requests are met and that disruptions to an institution’s normal course of business are minimized. Board members should be encouraged to attend any and/or all meetings conducted to provide for improved communication with outside directors and increased director knowledge of the examination process. These meetings also provide an opportunity for directors to discuss their views with examiners on banking related matters, and give examiners the opportunity to gain further insight into the experience levels and leadership qualities of bank management. While encouraging participation in these meetings, the EIC should emphasize that attendance is purely optional and voluntary and that a lack of participation will not be viewed negatively.

Pre-planning meetings designed to coordinate examination activities should address information requests (including the names of contact individuals), work space plans, and the

general scope of the examination. Other informal meetings should be held as needed throughout the examination to discuss various topics, and to gain management's perspective on local economic and bank-specific conditions and concerns. Prior to the conclusion of the examination, examiners should thoroughly discuss their findings and recommendations with senior management. Such meetings provide an opportunity for management to respond to examiner findings and recommendations and to clarify policies and procedures.

The following examples represent situations that will prompt meetings and encourage dialogue between examiners and management during the course of an examination. The circumstances of each examination will determine the type and number of meetings that will be necessary, as well as the degree of formality required to schedule and conduct the meetings.

Pre-Examination Planning. During the pre-planning phase of an examination, the EIC should contact senior management and request/obtain information and discuss any pertinent examination issues. Bank management should be encouraged to invite all directors to participate in regularly scheduled meetings with examiners or to schedule individual meetings with the EIC if that is the preference of the directors during this phase of the examination. Again, director participation is purely voluntary.

First Day. Generally, the EIC and examination team should meet with senior management and staff during the first day of the examination for introductions, to request additional information, and to discuss other general examination information. Such meetings provide an opportunity to establish open lines of communication.

Follow-up on Prior Examination Issues. Early in the examination, it is useful for the EIC to meet with senior management and discuss the bank's progress in responding to prior supervisory recommendations, as well as to recommendations of internal and external auditors. This is also a good opportunity for examiners to gain management's perspectives on bank-specific concerns and general economic conditions

Strategic Planning and Budget. The EIC and management should discuss asset and/or capital growth plans, new business or business products, and other strategic and budget issues during the course of the examination.

Loan Discussion. Management should participate in loan discussions and the initial review of adverse classifications, as appropriate, considering the size and condition of the institution.

Material Preliminary Findings. Normally, the EIC should notify senior management of major findings and recommendations before the final management meeting.

Management Meeting. Normally, all major examination issues should be formally discussed with senior management at the end of the examination, prior to meeting with the board of directors.

Regardless of the number or type of meetings held, it is critical that examiners ensure that on-going two-way communication takes place. Such communication allows both parties to freely exchange information, and enhances the effectiveness of the examination process.

Meetings with Directors

In order to encourage director involvement in and enhance director awareness of the FDIC's supervisory efforts and to increase the effectiveness of such efforts, policies have been established governing meetings with bank boards of directors. The bank's composite rating is the single most important variable in the decision as to if and when these meetings should be held. Specifics of the Division's policies are detailed below.

Banks Assigned or Likely to be Assigned a Composite 4 or 5 Rating

The EIC and the Regional Director or designee should meet with the board of directors (with the required quorum in attendance) during or subsequent to the examination. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the Regional Director's discretion.

Banks Assigned or Likely to be Assigned a Composite 3 Rating

The EIC should meet with the board (with the required quorum in attendance) during or subsequent to the examination. Regional Office representation is at the discretion of the Regional Director. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the discretion of the Regional Director or designee.

Banks Assigned or Likely to be Assigned a Composite Rating of 1 or 2

The EIC will meet with the board or a board committee during or subsequent to the examination when: 36 months or more have elapsed since the last such meeting; the management component of the CAMELS rating is 3, 4 or 5;

any other CAMELS performance rating is 4 or 5; or any two performance ratings are 3, 4 or 5. It is important to note that meeting with a board committee (in lieu of the entire board) in conjunction with an examination is permissible only when the committee is influential as to policy, meets regularly, contains reasonable outside director representation and reports regularly to the entire board. Other factors that may be relevant to the decision of whether or not to hold a board meeting include recent changes in control ownership and/or top management, economic conditions, request by management for a meeting and any unique conditions or trends pertinent to the institution. Regional Office participation in meetings with composite-rated 1 or 2 banks is at the Regional Director's discretion.

Other Considerations

When a meeting is held in conjunction with an examination, reference should be made on the Examination Conclusions and Comments schedule as to those committee or board members in attendance. A clear but concise presentation of the items covered at the meeting, including corrective commitments and/or reactions of management, should also be indicated. If the meeting is held, but not in conjunction with an examination, a summary of the meeting should be prepared and a copy mailed to the institution, via certified mail, for consideration by the board and inclusion in the official minutes of the directorate's next meeting. As above, this meeting summary should include the names of attendees and the corrective commitments and/or reactions of management.

When it is concluded that a meeting with a board committee rather than the full board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of board members who are not full time officers.

The success of the board meeting is highly dependent upon the examiner's preparation. A written agenda that lists all areas to be discussed and provides supporting documents or schedules will usually be worthwhile as a means of assisting in the explanation of certain aspects of the examination. Failure to adequately prepare for the meeting may substantially diminish the supervisory value of the examination.

To encourage awareness and participation, examiners should inform bank management that the examination report (or copies thereof) should be made available to each director for thorough and timely review and that a signature page is included in the examination report to be signed by each director after review of the report. Management should also be reminded that the report is confidential, remains the property of the FDIC, and that utmost care should be exercised in its reproduction and distribution. The bank should be advised to retrieve, destroy and record the fact of destruction of any reproduced copies when they have served their purpose.

OTHER SOURCES OF EXAMINATION INFORMATION AND POLICY GUIDANCE

As stated earlier, the primary purpose of this Manual is to provide policy guidance and direction to the field examiner that may then be applied in the safety and soundness examination process. Policy manuals or other instructional materials pertaining to other areas of examination interest, such as trust department operations, IT activities, transfer agent and consumer compliance, have also been developed. Those areas were not included in this Manual simply to enhance the organization of the material, keep the document reasonable in length, and thereby maximize its usefulness. However, exclusion of these topics in no way implies that these activities are not of interest to the safety and soundness examination. To the contrary, deficiencies in these other aspects of a bank's operations can have a major impact on the institution's overall soundness. Therefore, it is critical for the examiner to be aware of the existence and significance of any deficiencies in these other areas. Separate examination reports or schedules have been designed to evaluate these functions, and it is the Corporation's policy that such examinations generally should be conducted concurrently with the safety and soundness review. Some exceptions to this concurrent examination preference are permitted and are detailed in the instructions pertaining to these specialty areas.

To emphasize and illustrate how weaknesses in these ancillary activities can adversely affect the whole bank, a brief overview of trust, IT and compliance operations is provided.

Trust Department

A bank's trust department acts in a fiduciary capacity when the business it transacts, or the money or property it handles, is not its own or for its own benefit but belongs to and is for the benefit of others. This type of relationship clearly necessitates a great deal of confidence on the part of the bank's customers and demands a high degree of good faith and responsibility on the bank’s part. The primary objective of the trust department examination is to determine whether its operations or the administration of its accounts have given rise to possible or contingent liabilities, or direct liabilities (called estimated losses), which would reduce the bank's capital accounts. If the terms of trust instruments are

violated, if relevant laws and regulations are not complied with, or if generally accepted fiduciary standards are not adhered to, the department, and hence the bank, may become liable and suffer losses. Obviously, if the magnitude of these losses is sufficient, the viability of the bank may be threatened. To aid the examiner in evaluating the trust department, an interagency rating system has been devised. Composite ratings of 1 (highest level of performance) through 5 (most critically deficient level of performance) may be assigned, based on analysis of five critical areas of the department's administration and operations.

Information Technology (IT)

IT services apply to numerous recordkeeping and operational areas in banks. These IT services may be provided by the bank's own in-house computer system or the institution may arrange to have another financial institution or independent data center perform these functions. The potential consequences of receiving faulty data or suffering an interruption of services is serious and warrants comprehensive IT examination policies and procedures. A primary objective of the IT examination is to determine the validity and reliability of the records produced by the automated system; therefore, the emphasis is on an evaluation of internal controls. IT operations are rated by the examiner in accordance with the Uniform Interagency Rating System for Information Technology (URSIT) based on an evaluation of four critical components: audit, management, development and acquisition, and support and delivery. The data center composite or summary rating is predicated upon the separate performance ratings assigned these four functions. A scale of 1 through 5 is used, wherein 1 indicates strong performance and 5 denotes critically deficient operating performance.

Bank Secrecy Act (BSA)

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act of 1970 (31 U.S.C. 1051 et seq.) is often referred to as BSA. The purpose of the BSA is to require U.S. financial institutions to maintain appropriate records and file certain reports involving currency transactions and a financial institution's customer relationships. Several acts and regulations which expand and strengthen the scope and enforcement of BSA, anti-money laundering measures, and counter-terrorist financing measures have been signed into law and issued over the past several decades. Some of these include:

- Money Laundering Control Act of 1986
- Annuzio-Wylie Anti-Money Laundering Act of 1992
- Money Laundering Suppression Act of 1994
- Money Laundering and Financial Crimes Strategy Act of 1998
- USA PATRIOT Act enacted by Congress in October 2001

Findings from BSA examinations are generally included within the safety and soundness report. However, a separate BSA examination may be conducted in some instances. Refer to Examination Frequency discussed previously for additional guidance on separate BSA examinations. Although a separate rating system for BSA does not exist, the BSA findings can affect both the management ratings and the overall composite rating of the institution. Refer to the BSA section of this Manual for additional information.

Compliance

This term has become synonymous with those examinations that have as their principal objective the determination of a bank's adherence to various consumer protection and civil rights laws and regulations. These various statutes or regulations include, but are not limited to, Truth in Lending, Truth in Savings, the Community Reinvestment Act, and Fair Housing. Noncompliance with these regulatory restrictions and standards may result in an injustice to the individual(s) affected and reflects adversely on the capabilities of the institution's management. Moreover, violations of the consumer laws can entail civil liability in many cases and criminal liability in some. If significant in amount, such losses could conceivably have an adverse financial impact on the bank. As is the case for IT and trust operations, an interagency rating system for consumer compliance has been designed. It provides a general framework for evaluating the institution's present conformance with consumer protection and civil rights laws and regulations, except for the Community Reinvestment Act, and for assessing the adequacy of its operating systems to ensure continued compliance. A numbering scheme of 1 through 5 is used with 1 signifying the best performance and 5 the worst. A separate examination rating is assigned to each institution based on its performance in the area of community reinvestment. The four ratings are outstanding, satisfactory, needs to improve, and substantial noncompliance.

In order to perform their duties properly, examiners must be knowledgeable of the principles, policies and practices contained in the aforementioned handbooks on IT, compliance, trust and others. There are other reference sources also very relevant to the examination process and with which it is essential for the examiner to become familiar. These include the body of State laws and regulations that apply to the bank being examined; the rules, regulations, statements of policy and various banking-related statutes contained in the Prentice-Hall volumes; and the instructions for completion of the Consolidated Reports of Condition and Income. The last mentioned source is the principal reference

for balance sheet and income statement presentation of various transactions and accounts in both the foregoing Reports and the Report of Examination.

DISCLOSURE OF REPORTS OF EXAMINATION

The Report of Examination is highly confidential. Although a copy is provided to the bank, that copy remains the property of the FDIC. Without the FDIC's prior authorization, directors, officers, employees and agents of a bank are not permitted to disclose the contents of a report. Under specified circumstances, FDIC regulations permit disclosures by a bank to its parent holding company or majority shareholder.

FDIC regulations do not prohibit employees or agents of a bank from reviewing the Report of Examination if it is necessary for purposes of their employment. Accountants and attorneys acting in their capacities as bank "employees" or agents may review an examination report without prior FDIC approval, but only insofar as it relates to their scope of employment. The Division believes the definition of "agent" includes an accountant or accounting firm which performs an audit of the bank.

Reports of Examination are routinely provided to the bank's chartering authority. Therefore, State bank examiners may review the bank's copy of an FDIC examination during a State examination.

EXAMINATION WORKPAPERS

Introduction

Examination findings should be documented through a combination of brief summaries, bank source documents, report comments, and other examination workpapers that address both management practices and condition. Examination documentation should demonstrate a clear trail of decisions and supporting logic within a given area. Documentation should provide written support for examination and verification procedures performed, conclusions reached, and support the assertions of fact or opinion in the financial schedules and narrative comments in the Report of Examination.

The documentation should include a summary statement, which at a minimum:

- Provides a summation of the documentation relied upon during the review;
- Briefly details the procedures used and analyses conducted to support conclusions relative to the assigned CAMELS components, BSA examination findings, and other significant areas of review; and
- Capsulizes any material discussions with management.

Summary statements can take many forms, including notations on copies of the source documents, a separate hand-written comment, use of an ED module, and/or a document prepared electronically, with a hard copy maintained in the appropriate file

Examination Documentation (ED) Modules

Examination procedure modules have been developed jointly by the FDIC and the Federal Reserve to provide examiners with a tool to focus on risk management and establish an appropriate examination scope. The use of these modules is discretionary. When not used, examination findings should be documented as discussed above.

The modules incorporate questions and points of consideration into examination procedures to specifically address a bank’s risk management strategies for each of its major business activities. The modules direct examiners to consider areas of potential risk and associated risk control practices, thereby facilitating an effective supervisory program. The guidelines set forth standards or “best practices” and the risks associated with not meeting the standards. The ED module examination procedures are separated into three distinct tiers: Core Analysis; Expanded Analysis; and Impact Analysis. The extent to which an examiner works through each of these levels of analysis depends upon conclusions reached regarding the presence of significant concerns or deficiencies. The modules are contained on the Bank Examiner’s Reference CD.

Where significant deficiencies or weaknesses are noted in the core analysis review, the examiner should complete the Expanded Analysis section but only for those decision factors that present the greatest degree of risk to the bank. On the other hand, if the risks are properly managed, the examiner can conclude the review after documenting conclusions concerning the Core Analysis Decision Factors and carry any comments to the Report of Examination. The Expanded Analysis section provides guidance to the examiner in determining if weaknesses are material to the bank’s condition and if the activity is adequately managed.

The use of the modules should be tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module is completed will vary from bank to bank. Individual

procedures presented for each level are meant only to serve as a guide for answering the decision factors. Each procedure does not require an individual response; however, the automation allows for notes under each procedure. If ED modules are utilized, examiners are required to document their responses to both the Core Analysis Decision Factors and the Expanded Analysis Decision Factors.

Substance of Workpapers

All workpapers should be labeled with the institution's name and location, dated, and signed or initialed by the examiner or pre-commissioned examiner who prepared the document. A checklist of examination procedures performed may be used to document completed tasks and included as part of the examination workpapers. Documentation should be prepared and retained in the workpapers for each significant job task performed. The Checklist could be used as the final documentation for those areas reviewed where findings are not material. The EIC has discretion as to the extent of the documentation; however, as already stated, minimal documentation will likely be necessary in areas with limited risk. The EIC always has the discretion to use the applicable ED modules for documentation support.

Examiners should use standardized loan line sheets except in special situations where alternative forms, such as institution generated automated line sheets, provide a clear and substantial time savings and the same general loan information. Line sheets will contain sufficient supporting data to substantiate the pass or adverse classification of a line.

For BSA examinations, workpaper documentation should support the conclusions included in the ED module. At a minimum this documentation should support the examiner's assessment of the bank's BSA and anti-money laundering programs and procedures; the related audit or internal review function; the bank's information and communication systems; compliance with regulations; and related training.

For selected areas of examination activity, workpaper forms have been created in GENESYS and are available as supplements to the respective report pages or ED modules. Additional guidance for their use is included in the Report of Examination Instructions. When examiner concerns warrant it, any supplemental workpaper form may be included in the Report of Examination.

Filing of Workpapers

Workpapers relating to various major assignments (i.e. earnings, capital, balance sheet, etc.) should be segregated and placed in separate folders, envelopes, or binders. (If binders are used, workpapers for a number of major assignments can be incorporated into one binder if it is properly indexed with the required information). Workpapers generated for the evaluation of internal routine and controls may be filed together under one major heading or separately under the major categories reviewed. Line cards should be segregated from other workpapers, alphabetized, and securely banded. BSA workpapers should be maintained separately from the workpapers of the regular safety and soundness examination. The separate retention of BSA workpapers will expedite their submission in the event that the Treasury Department requests them during an investigation.

Each folder, envelope, or binder should be appropriately labeled with the institution's name and location, the date of examination, and a list of documents that have been prepared and retained for each category. At its discretion, each region and field office may designate the major categories and supplemental lists for their respective office(s). The workpaper folders, envelopes, or binders should then be organized in a labeled box, expandable file, or other appropriate centralized filing system and retained at the conclusion of the examination. The EIC is responsible for ensuring that examination workpapers are properly compiled and satisfactorily organized.

Retention of Workpapers

Line sheets should be retained for one examination beyond the examination at which they are purged from the active loan deck. The Safety and Soundness Officer's Questionnaire, BSA Officer's Questionnaire, and BSA workpapers must be retained for a minimum period of five years from the examination start date. The Officer's Questionnaire should be retained indefinitely when irregularities are discovered or suspected, especially if the signed questionnaire may provide evidence of these irregularities. The examiner may submit the Officer's Questionnaire with the Report of Examination if circumstances warrant, such as when the examiner suspects that an officer knowingly provided incorrect information on the document. Retention of other workpapers beyond one examination should generally be confined to those banks with existing or pending administrative actions, special documents relating to past insider abuse, documents which are the subject of previous criminal referral letters, or other such sensitive documents. While the retention of workpapers beyond one examination is generally discouraged, major schedules such as earnings, balance sheets, board minutes, and other pertinent workpapers can be retained if deemed useful.