REVIEW OF DCA POLICY FOR DETERMINING EXAMINATION FREQUENCY, SCOPE, AND PRIORITY

Audit Report No. 99-013
March 15, 1999

OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

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FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General

DATE: March 15, 1999

MEMORANDUM TO: Ronald F. Bieker, Acting Director
Division of Compliance and Consumer Affairs

FROM: David H. Loewenstein
Assistant Inspector General

SUBJECT: *Review of DCA Policy for Determining Examination Frequency, Scope, and Priority*
(Audit Report No. 99-013)

The Federal Deposit Insurance Corporation (FDIC) Office of Inspector General has completed a review of the Division of Compliance and Consumer Affairs (DCA) policy for determining the frequency, scope, and priority of compliance and Community Reinvestment Act (CRA) examinations for FDIC-insured state nonmember institutions.

On January 26, 1998, DCA issued a new policy entitled "Risk Management Priorities" that directly addressed the frequency, scope, and priority of examinations. DCA intended for this policy to improve risk management procedures for conducting examinations within DCA's existing resources. The policy extends the full-scope examination frequencies for up to 5 years and requires examiners to evaluate compliance with certain laws and regulations using "aggressive scoping procedures" (eliminating or reducing the review for certain laws and regulations) "to the greatest extent possible" to save time during compliance examinations. This policy permits changes to DCA's examination process that would make it different from the compliance programs at the other federal bank regulatory agencies. Moreover, we are concerned that the extended examination cycle and reduced testing of certain regulations could diminish FDIC's ability to adequately enforce consumer protections under the law and may give banks and the public the perception that the FDIC has placed a lower priority on conducting these examinations.

In addition, we are concerned that DCA has redefined its internal control risk assessment and lowered its risk ranking for its compliance reviews. In light of DCA's 1998 policy to extend examination frequencies and to aggressively scope reviews of bank compliance with consumer protection laws and regulations, the internal control risk assessment should be re-examined.

BACKGROUND

The FDIC is legislatively authorized to enforce compliance with various laws and regulations related to consumer protections and civil rights with respect to insured state-chartered nonmember banks. Table 2 on page 11 contains a listing of the subject laws and regulations. Insured state-chartered nonmember banks are banks that are insured by the FDIC, chartered by the state in which they operate, and not members of the Federal Reserve System. In addition to ensuring compliance with consumer protection laws and regulations, the FDIC is responsible for monitoring the CRA activities of these non-member institutions. Enacted in 1977, the CRA was intended to encourage federally-insured depository institutions to lend in low- and moderate-income neighborhoods.

FDIC established DCA as a separate division in 1994 to conduct examinations to determine compliance with consumer protection, civil rights, and fair housing laws and regulations. Previously, the Division of Supervision conducted these reviews as part of the Division's safety and soundness examinations. Noncompliance with consumer protection laws may result in corrective enforcement actions requiring payment of restitution or penalties, or reimbursement to customers of improperly charged fees or interest. As required by the CRA, DCA also periodically evaluates each institution's record of helping to meet the credit needs of the bank's entire community. Noncompliance with CRA may result in adverse publicity that can impact negatively on the bank's ability to continue servicing existing relationships, and to establish new relationships and services within the community.

There are no federally mandated examination frequency requirements for compliance or CRA examinations. In May 1996, the FDIC Operating Committee agreed to a maximum 36-month examination frequency schedule for FDIC-supervised financial institutions with composite ratings of "1" or "2" for compliance and "Outstanding" or "Satisfactory" ratings for CRA. Previously, these institutions were evaluated on a 24-month examination cycle. Institutions rated "3" for compliance continued to have a 24-month examination cycle. The frequency schedule for institutions with composite ratings of "4" or "5" for compliance, and "Needs to Improve" or "Substantial Noncompliance" ratings for CRA remained at 12 months.

OBJECTIVES, SCOPE, AND METHODOLOGY

We reviewed the policy for determining examination frequency, scope, and priority in the DCA Atlanta Regional Office. The initial objectives of the audit were to determine whether: (1) examinations are conducted in compliance with FDIC policies and procedures related to the frequency of examinations, (2) examinations are conducted in a manner that ensures the consistency of the scope of the reviews, (3) and examination priorities are identified and addressed in a timely manner. However, the scope of our audit changed during the field work phase of our audit due to the January 1998 issuance of a new DCA policy entitled "Risk Management Priorities" which directly addressed the frequency, scope, and priority of DCA examinations. The purpose of the change in audit scope was to focus on the risks associated with the new policy as it relates to extended examination frequencies and methods used to identify compliance risk in FDIC-supervised institutions.

To accomplish the audit objectives, we reviewed compliance and CRA examinations conducted from January 1997 through March 1998 on 40 banks ranging in size from $10 million to $1.6 billion. Our audit work included reviewing DCA policies and procedures, examination reports and workpapers, examination statistics, and internal control management reports. In addition, we discussed the process for determining examination frequencies,scoping requirements, and off-site monitoring of institutions with various officials in DCA headquarters, officials and examiners in the Atlanta Regional Office, and officials from the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). We also met with the Chairman of the Consumer Compliance Task Force for the Federal Financial Institutions Examination Council (FFIEC).

Our fieldwork also included

- comparisons of examination frequencies and scopes under old and new DCA policies;
- reviews of Office of Internal Control Management guidance related to management control plans and internal control reviews;
- reviews of the DCA 1995 – 1998 management control plans;
- a review of the regulations related to the FFIEC and projects currently in process under the Consumer Compliance Task Force; and
- a comparison of DCA's compliance and CRA examination programs with the programs of the other federal bank regulatory agencies.

We obtained examination information from the Compliance Statistical System, DCA's automated examination tracking system, but we did not independently test the system, since it was being redesigned at the time of our review. The audit was conducted in accordance with generally accepted government auditing standards. We conducted the audit fieldwork in DCA Washington headquarters and the Atlanta Regional Office from January 9, 1998 though September 17, 1998.

RESULTS OF AUDIT

In January 1998, during the course of our audit, DCA revised its policy on examination frequency, scope, and priority. The new policy, which allows for a period of up to five years between full-scope examinations for an estimated 90 percent of FDIC-supervised banks, extends the FDIC review cycle longer than that of any other federal financial regulatory agency. The policy also directs examiners to use “aggressive scoping procedures” (eliminating or reducing the review for certain laws and regulations), potentially omitting reviews of certain consumer protection requirements. It is DCA’s opinion that aggressive scoping will reduce examination hours and improve efficiency. According to the DCA policy, eliminating the hours spent on low-risk regulations will allow the DCA to focus resources and increase the pace of examinations.

In addition, in 1996 DCA redefined its internal control risk assessment related to meeting examination frequency requirements and detecting noncompliance by banks, and in 1997 DCA lowered the associated risk ranking from “Medium” to “Low.”   However, in light of DCA’s 1998 policy to extend examination frequencies and to aggressively scope reviews of bank compliance with consumer protection laws and regulations, the internal control risk assessment should be reexamined.

DCA’S POLICY ON RISK MANAGEMENT PRIORITIES PLACES FDIC AT A GREATER RISK OF NOT DETECTING INSTANCES OF NONCOMPLIANCE

From 1996 until early 1998, DCA operated under an FDIC policy requiring full-scope compliance examinations to be performed at least once every three years of those banks for which the FDIC is the primary federal regulator. This policy was consistent with the policies of the other federal bank regulatory agencies. However, in January 1998, DCA issued Policy Memorandum 6410.14, “Risk Management Priorities,” to improve risk management procedures for conducting examinations within existing resources. Among other things, the new policy provides:

> “Examinations of institutions rated any combination of “1” or “2” in Compliance and “Outstanding” or “Satisfactory” for CRA (regardless of size), may be deferred for up to two years (for a total of five years between examinations) if an on-site Interim Visitation is conducted within the three-year time frame.”[1]

The Risk Management Priorities policy goes on to state that the intent is to ensure an on-site presence in all banks at least every three years. However, DCA staffing estimates and work load assumptions for 1999 – 2003 (dated July and August 1998, respectively) estimate that there will be a significant number of delinquent examinations, ranging from 699 in 1999 to 395 in 2001. Further, according to the policy, DCA believes that compliance with the new policy may not be achieved on a national basis until year-end 2000, and DCA estimates that 90 percent of FDIC-insured banks will be eligible for the two year deferral for the full-scope examinations.

DCA issued the 1998 Risk Management Priorities policy as a temporary measure to address DCA examination delinquencies. The policy specifically states:

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[1] The Interim Visitation program is a narrowly scoped review with limited on-site work. If compliance problems are detected during the Interim Visitation, a full-scope compliance examination can be started. The scope of the review focuses on changes in a bank’s compliance operations; however, there is no requirement that loan files be sampled. DCA will not assign ratings to a bank based on an Interim Visitation. DCA estimates that the Interim Visitation will take 40 to 80 hours, depending on the size of the bank. In contrast, as of June 30, 1998, a full-scope examination of a bank averaged 177 hours and resulted in a formal rating of bank compliance.

> "This policy is intended to ensure we have an on-site presence in all FDIC-supervised financial institutions at least every three years. Since there is currently a significant number of delinquent examinations, this policy is to be applied prospectively and compliance may not be entirely achieved on a national basis until year-end 2000."

According to DCA officials and the Division of Administration Associate Director for Management Review, there was no FDIC Board presentation and no formal Board vote to extend examinations up to 5 years. However, DCA representatives briefed Board members individually to explain the need for and the purpose of the policy to extend examination frequencies. According to DCA officials, the policy was also presented to the FDIC Operating Committee as a part of the DCA core staffing request.

This policy extends DCA's examination frequency beyond that of any other federal bank regulatory agency. While federal laws and regulations do not contain specific requirements for compliance examination frequency, scope, or priority, the Congress did intend that there be some degree of consistency among federal regulators in their compliance reviews. The FFIEC was established by the Congress to promote improved and consistent examination and supervision policies and procedures among the five financial institution regulatory agencies. We found that other federal bank regulators continue to require compliance examinations at least once every three years of all banks for which they are the primary federal regulator.

In addition to changing the frequency of full-scope reviews, the DCA policy lists nine consumer protection laws and regulations that "should be evaluated using aggressive scoping procedures to the greatest extent possible." "Aggressive scoping procedures" allow examiners to completely eliminate or significantly reduce efforts for certain laws and regulations when planning their reviews, potentially omitting reviews of these consumer protection requirements. The nine laws and regulations to be aggressively scoped are as follows:

- Consumer Leasing Act – FRB Reg M
- Interest on Deposits – FRB Regulation Q / 12 CFR Part 329
- Preservation of Consumer Claims and Defenses – FTC Rule Part 433
- Flood Disaster Protection Act
- Credit Practices Rule – FRB Regulation AA
- Right to Financial Privacy Act
- Expedited Funds Availability Act – FRB Reg CC
- Electronic Funds Transfer Act – FRB Reg E
- Truth In Savings Act – FRB Reg DD

The policy memorandum states that these laws and regulations

> "… are considered to pose the least amount of risk to the financial institution, the general public, and the FDIC. While reviewing for compliance with some of these regulations may not take much time, any time saved during the examination is a positive shift toward maximizing our efficiency. Eliminating the hours spent on many of the low-risk regulations

> normally reviewed during an examination will allow us to focus resources on the higher risk areas and should increase the pace of examinations."

DCA management officials told us that they did not document the methodology for selecting these nine laws and regulations.

We found information, some internal to DCA, that is not consistent with DCA's study of violations. An FDIC Financial Institution Letter (FIL) 87-97 entitled "Consumer Protection and Fair Lending Compliance Violations Most Often Cited by FDIC Examiners in 1996" was issued September 2, 1997, four months before the new policy was issued. In this FIL, DCA identified 10 consumer laws and regulations as the areas most often cited during the compliance examinations of 2,031 institutions conducted in 1996 (see Table 3 on page 12). Four of these laws were targeted for aggressive scoping by DCA in its January 1998 policy: the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Flood Disaster Protection Act, and the Truth in Savings Act.

Also, in the July/August 1998 issue of the American Banker Association (ABA) Bank Compliance publication, the ABA presented compliance examination data from the FRB, the OCC, and the FDIC and tracked the 11 most common violations found during their examinations. Again, four of the nine laws and regulations targeted for aggressive scoping by DCA were identified as commonly cited for violations: the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Flood Disaster Protection Act, and the Truth in Savings Act.

In addition, we reviewed the number of violations cited in our sample of 40 banks that were examined in the DCA Atlanta region from January 1997 through March 1998. We found that even banks with composite compliance ratings of "1" and "2" had violations noted on seven of the laws and regulations identified for aggressive scoping. Table 1 below summarizes the results of our analysis.

TABLE 1
VIOLATIONS FOUND IN 40 BANKS WITH COMPLIANCE RATINGS OF "1" AND "2"

LAWS / REGULATIONS IDENTIFIED FOR AGGRESSIVE SCOPING	# OF BANKS WITH VIOLATIONS	% OF BANKS WITH VIOLATIONS
Expedited Funds Availability Act – FRB Reg CC	21	52%
Flood Disaster Protection Act	19	47%
Truth In Savings Act – FRB Reg DD	16	40%
Interest on Deposits – FRB Regulation Q / 12 CFR Part 329	11	27%
Electronic Funds Transfer Act – FRB Reg E	10	25%
Credit Practices Rule – FRB Regulation AA	3	7%
Right to Financial Privacy Act	2	5%
Preservation of Consumer Claims and Defenses – FTC Rule Part 433	0	0%
Consumer Leasing Act – FRB Reg M	0	0%

Source: OIG Analysis of 40 DCA Compliance Examinations

We believe the longer examination frequency intervals, combined with decreased coverage of certain consumer protections, may not ensure that compliance and CRA concerns will be identified and addressed in a timely manner. Furthermore, by extending examination frequencies, the DCA “Risk Management Priorities” policy may leave the FDIC open to adverse public exposure by giving banks and the public the perception that the FDIC has placed a lower priority on conducting compliance and CRA examinations as compared with other regulatory agencies.

Although DCA headquarters management told us that the 9 regulations to be aggressively scoped had the fewest number of violations nationwide,we believe the results of our sample of 40 banks, cited above, demonstrate a need to evaluate risk separately at each individual bank. Banks nationwide operate in very different environments, serve different clients, and offer different services. In our opinion, nationwide results of bank examinations should not be used to scope the review of laws and regulations at each individual bank. In addition, the banking environment is changing rapidly. Although some regulations, such as those related to financial privacy, may not have had many violations reported in the past, we believe there could be more violations in the future as electronic banking and commerce technology continues to develop. DCA needs to take a more proactive approach in assessing risk by looking forward, not back, in time. We believe the intent of a risk management approach to conducting compliance examinations should allow examiners to evaluate the risk of individual banks and to focus their review and testing based on specific bank risk assessment results.

Recommendations

To ensure that consumer protection laws and regulations are followed by banks and to confirm the importance the FDIC places on consumer protection requirements, we recommend that the Acting Director, DCA:

(1) Conduct an overall risk assessment study, based on current data and evolving trends, to determine the appropriate review cycles and appropriate methods to use when scoping and conducting compliance and CRA examinations.

(2) Initiate a dialogue with the other federal bank regulatory agencies (possibly through the FFIEC) to determine the adequacy of examination frequency requirements and consistent methods for meeting these requirements.

(3) Revise Policy Memorandum 6410.14, Risk Management Priorities, by eliminating the direction for examiners to aggressively scope the nine cited consumer protection laws and regulations and instead directing examiners to conduct examinations focusing on individual bank risk assessments.

DCA'S CURRENT INTERNAL CONTROL RISK RANKING IS INCONSISTENT WITH ITS POLICY ON RISK MANAGEMENT PRIORITIES

In 1996, DCA redefined its internal control risk assessment related to conducting compliance examinations by combining the risk related to meeting examination frequency requirements with the risk related to detecting noncompliance by banks. Prior to the change, both of these risks were ranked as "Medium." During 1997, DCA reduced its internal control risk ranking for conducting compliance examinations from "Medium" to "Low." However, in light of DCA's 1998 policy to extend examination frequencies and to aggressively scope reviews of bank compliance with consumer protection laws and regulations, the internal control risk assessment should be reexamined.

The Chief Financial Officers Act (CFOA) of 1990 requires government corporations, including the FDIC, to submit annual management reports to the Congress signed by the head of the agency. In compliance with the CFOA, each FDIC division and office is responsible for: establishing Accountability Units (AU) linked to business activities/functions, identifying risks, establishing control objectives, and developing risk management control plans to evaluate internal control standards. The Internal Control Review (ICR) is the evaluation and verification process used to provide reasonable assurance that internal controls, as well as business and administrative practices, are working as planned and that risks are effectively managed. Each division and office performs ICRs specific to their organization (commonly referred to as Site Visitation Programs or Program Compliance Reviews).

In its 1996 through 1998 Management Control Plans, DCA defined its first risk for the Supervision and Regulations Branch as "Compliance examinations not performed in accordance with established frequency schedules may increase the possibility of institutions not complying with all applicable consumer protection and fair lending laws and regulations." DCA's Management Control Plan for 1995 defined two separate risks for this are--one for the detection of noncompliance in banks and one for its ability to meet examination frequency requirements. In the 1995 Plan, DCA rated each risk separately and each of these risks was given a "Medium" risk ranking. In 1996, DCA combined these two risk elements into one, as quoted above, and in 1997 DCA lowered the risk ranking for the combined risk area to a "Low" risk.

The Office of Internal Control Management (OICM) reviews all of the FDIC internal control assessments. The OICM Interim Guidance on Internal Control Programs, dated January 1997, directed that: the number of AUs identified by each division or office be reviewed and streamlined, ultimately cutting down on the number that would have to be tracked; and AUs be established at the highest level that would lend itself to efficient and effective internal control review. The guidance further stated that while individual components of an AU may have varying levels of associated risk, an overall risk ranking at the AU level should provide a meaningful assessment of susceptibility of a program or function to the occurrence of waste, loss unauthorized use or misappropriations.

According to DCA, the risk areas related to the detection of noncompliance in banks and the DCA's ability to meet examination frequency requirements were combined, in accordance with the OICM guidance, because they were similar and closely aligned. It is OICM's opinion that, although it would appear a "High" risk ranking might be appropriate for the combined DCA risk area, the area is being adequately monitored. According to OICM, a risk ranking of "High" would require an annual review of the internal controls for the associated accountability unit. Because DCA conducts several regional office reviews each year that include reviews of the control points included in its Management Control Plan, OICM believes the requirement for annual reviews is already satisfied, just as though DCA had assessed this as a "High" risk area. According to DCA officials, regional and field office reviews are conducted on two year and three year cycles, respectively, covering four of the eight DCA regional offices per year.

In light of DCA's 1998 policy to extend examination frequencies and to aggressively scope reviews of bank compliance with consumer protection laws and regulations, the internal control risk assessment should be reexamined. By extending the examination cycle to as much as five years, DCA's January 1998 policy memorandum actually may increase the risk of not detecting noncompliance. Because the risk ranking dictates the frequency with which controls must be assessed by the divisions and offices, lowering the risk ranking over controls to detect noncompliance could result in less scrutiny of the area should DCA decide not to continue with its annual regional office reviews.

In addition, we believe the actual "risk" for DCA is, as stated in its 1995 Management Control Plan, the risk of not detecting noncompliance with applicable consumer protection and fair lending laws and regulations. We also believe that the risk of not detecting noncompliance in a timely manner is currently higher for the following reasons:

- DCA has permitted the compliance examination cycle to be extended as much as five years between full-scope examinations, longer than that of any other federal bank regulatory agency.

- When full-scope examinations are conducted, DCA procedures require examiners, at a minimum, to review a sample of transactions dating back six months to 2 years; leaving 3 years of transactions out of the universe for testing. Therefore, under the revised policy, if an examination is deferred for up to five years between examinations, transactions occurring in the first three years of this period may never be reviewed.

- Supervisors do not regularly review the examination working papers that support examination conclusions. According to DCA, the only regular oversight is performed during the regional office reviews and field office reviews conducted by DCA staff on two-year and three-year cycles, respectively.

Recommendations

To more accurately reflect the effect of extending the frequency requirements for full-scope compliance examinations, we recommend that the Acting Director, DCA:

(4) Revise the DCA Management Control Plan to separately identify and evaluate the risk of: (a) not detecting instances of noncompliance in banks, and (b) not meeting the examination frequency requirements established in DCA policy.

(5) Re-evaluate the risk areas defined in recommendation 4, and assign higher risk rankings to more accurately reflect the lengthening of review cycles, staff shortages, lack of supervisory reviews of examination workpapers, or any future changes made to the frequency, scope, or priority of compliance examinations.

CORPORATION COMMENTS AND OIG EVALUATION

On March 2, 1999, the Acting Director of DCA provided a written response to the draft report. This response is presented in Appendix I of this report.

In response to recommendations 1, 2, and 3, the Acting Director, DCA, stated that DCA Policy Memorandum 6410.14, entitled “Risk Management Priorities,” will be superceded, and compliance examiners will be required to follow the existing guidelines contained in the DCA Compliance Examination Manual. The policy was issued as a temporary measure intended to provide regions with a discretionary tool (i.e., Interim Visitation) that could assist them in complying with the FDIC’s January 1998 goal of having an on-site presence in all institutions over the subsequent 3-year period. The temporary policy has been used only sparingly by the regions, and no more than five Interim Visitations were performed in 1998.

The Acting Director also agreed with recommendation 4, and DCA will separately identify and evaluate the risk areas related to the detection of noncompliance in banks and DCA's ability to meet examination frequency requirements. For recommendation 5, the Acting Director stated that DCA management determined that the risk assessment for the Supervision and Regulation Accountability Unit, which was completed and issued in February 1998, resulted in a low risk ranking. DCA management reaffirmed the risk ranking level of the Accountability Unit in the Management Control Plan submitted to OICM on February 16, 1999, and will re-evaluate the risk ranking level in the fourth quarter 1999 for the year 2000 Management Control Plan submission.

These actions adequately address our audit concerns. In addition, the Corporation’s response to the draft report provided the elements necessary for management decisions on the report’s recommendations. Appendix II presents management’s proposed actions on our recommendations and shows that there is a management decision for each recommendation in this report.

TABLE 2

CONSUMER PROTECTION LAWS AND REGULATIONS

Advertisement of FDIC Membership – FDIC Part 328
Community Reinvestment Act
Consumer Leasing Act
Credit Practices Rule – FRB Regulation AA
Electronic Funds Transfer Act
Equal Credit Opportunity Act
Expedited Funds Availability Act
Fair Credit Reporting Act
Fair Debt Collection Practices Act
Fair Housing Act
Flood Disaster Protection Act
Home Mortgage Disclosure Act
Interest on Deposits – FRB Regulation Q
Preservation of Consumer Claims and Defenses – FTC Rule Part 433
Real Estate Settlement Procedures Act
Right to Financial Privacy Act
Truth in Lending Act
Truth in Savings Act

Source: DCA Compliance Examination Manual, dated May 1998

TABLE 3

COMMON COMPLIANCE VIOLATIONS FOR 1996 DCA EXAMINATIONS

LAWS/ REGULATIONS	# OF BANKS WITH VIOLATIONS (*)	% OF BANKS WITH VIOLATIONS
Truth in Lending Act	1547	76
Real Estate Settlement Procedures Act	1528	75
Equal Credit Opportunity Act	1238	61
Fair Housing Act	1237	61
Truth in Savings Act	1036	51
Flood Disaster Protection Act	953	47
Expedited Funds Availability Act	919	45
Home Mortgage Disclosure Act	662	33
Fair Credit Reporting Act	509	25
Electronic Funds Transfer Act	444	22

(*) Total number of banks examined = 2,031

Source: FDIC Financial Institution Letter #87-97, entitled *Consumer Protection and Fair Lending Compliance Violations Most Often Cited by FDIC Examiners in 1996,* dated September 2, 1997.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429 **Division of Compliance and Consumer Affairs**

March 2, 1999

MEMORANDUM TO: David H. Loewenstein
Assistant Inspector General

FROM: Ronald F. Bieker
Acting Director
Division of Compliance and Consumer Affairs

SUBJECT: Response to Draft Report Entitled
Review of DCA Policy for Determining Examination Frequency, Scope, and Priority

As requested, this memorandum presents the Division of Compliance and Consumer Affairs comments and recommendations with regard to the above referenced draft report in both hard copy and electronic format.

Recommendation 1, 2, and 3 in the OIG draft report focuses on the release and implementation of DCA's January 1998 Policy Memorandum 6410.14, "Risk Management Priorities.

DCA issued the 1998 "Risk Management Priorities" policy to improve risk management procedures for conducting examinations within existing resources. The intent of the policy was to ensure that DCA had an on site presence in all FDIC-supervised financial institutions at least every three years.

The OIG draft report states that by extending the examination frequencies, the DCA "Risk Management Priorities " policy may not ensure that compliance and CRA concerns are identified and addressed in a timely manner. Also, the policy may leave the FDIC open to adverse public exposure by giving banks and the public the perception that the FDIC has placed a lower priority on conducting compliance and CRA examinations as compared to the other regulatory agencies. Furthermore, the OIG states that DCA should conduct its compliance and CRA examinations by evaluating institutional risk on a case-by-case basis.

DCA would like to point out that the "Risk Management Priorities" policy was issued as a temporary measure intended to provide regions with a discretionary tool (i.e., Interim Visitation) that could assist them in complying with the FDIC's January 1998 goal of having an on-site presence in all institutions over the subsequent three-year period. Although temporary adjustments to the frequency schedule have been made to help regions manage a large volume of delinquent exams, the official schedule remained in effect for 1998 and will continue to be the standard by which examinations are scheduled and delinquencies are determined.

In fact, the temporary policy has been used only sparingly by the regions and has had no significant impact on overall compliance with the division's official examination frequency schedule (1-year, 2-year, or 3-year cycle depending on asset size and rating). No more than five Interim Visitations were performed in 1998 and as of January 15, 1999, only one bank (pending merger) among 5,947 was more than two years delinquent, based on the official schedule.

As reported in the 1998 year-end Annual Performance Plan, DCA started 1,989 examinations as compared to the original projection of 1,610 examinations in the 1998 Core Staffing submission, completed in the fourth quarter 1997. In 1999, DCA projects starting 2,315 examination. The number of these examination starts not only results in DCA adhering to its official examination frequency schedule, but also indicates that DCA will significantly reduce the number of examination delinquencies.

DCA has compared its exam frequency schedule with the OTS, FRB, and OCC and determined that the official examination schedule is fully consistent with the other supervisory agencies. FDIC has and will continue to maintain an in-depth dialogue with other federal agencies. In fact, DCA currently chairs the FFIEC Consumer Compliance Task Force Examination Subcommittee, which specifically addresses, consistency of all examination-related activity among the supervisory agencies, including examination frequency requirements and the application of a consistent methodology.

Finally, DCA fully agrees with the OIG regarding the appropriateness of evaluating institutional risk on a case-by-case basis and is committed to managing the compliance examination program in accordance with that philosophy. In fact DCA's compliance examination policies and procedures manual clearly states that the examiner should conduct the appropriate risk evaluation on each examination.

To ensure that DCA remains focused on adhering to the official examination frequency schedule as well as applying the appropriate risk management procedures as presented in the Compliance Manual, DCA will issue a Memorandum to all staff superceding the January 1998 Policy Memorandum 6410.14, "Risk Management Priorities".

DCA anticipates completing this action, and providing a copy of the Memorandum to the OIG no later than March 31, 1999.

Recommendation 4 of the draft audit report suggest that DCA's Management Control Plan separately identify and evaluate the risk of: (a) not detecting instances of noncompliance in banks, and (b) not meeting the examination frequency requirements established in the DCA policy.

As presented in the OIG report, in 1997 DCA combined the risk areas related to the detection of noncompliance in banks and DCA's ability to meet examination frequency requirements because they were so closely aligned. This was a management decision to streamline the risk reporting in the MCP as requested by the OICM. Although the risks were combined, the testing associated with those separate risks was maintained in both the Regional and Field Office ICRs.

DCA has no problem with separating out the currently combined risks. We will submit the change to OICM for consideration.

DCA anticipates completing this action and providing a copy of the Management Control Plan to the OIG no later than March 31, 1999.

Recommendation 5 of the draft report suggest that DCA reevaluate the Supervision and Regulation Accountability Unit risk ranking to more accurately reflect the lengthening of the review cycles or any other future changes made to the frequency, scope, or priority of compliance examinations.

DCA management determined that the Supervision and Regulation Accountability Unit, which was completed and issued in February 1998, would have a low risk ranking. DCA management reaffirmed the risk ranking level of the Accountability Unit in the Management Control Plan submitted to OICM on February 16, 1999.

As discussed under our response to recommendation 1, 2, and 3, DCA has not incurred an additional lengthening of examinations. In fact, DCA has maintained the official examination frequency schedule and continues to reduce the number of delinquencies. Also, the FDIC supervised financial institutions were, and remain today, very healthy. Not only were the financial institutions very strong, but they were very much in compliance with Consumer Protection and CRA Laws and Regulations. The percentage of FDIC supervised institutions with Compliance and a CRA examination rating of 1 or 2 was 95% and 99%, respectively.

In conjunction with separating out the risks identified in recommendation 4 noted above, DCA will evaluate the risk ranking level in the fourth quarter 1999 for the year 2000 Management Control Plan submission. Upon completion and OICM approval, we will provide a copy of the Management Control Plan to the OIG.

If you have any questions please, contact Melissa D'Onofrio, Associate Director for Operations at 202-942-3223.

APPENDIX II

MANAGEMENT RESPONSES TO RECOMMENDATIONS

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

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

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

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

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

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	DCA will supercede Policy Memorandum 6410.14, entitled "Risk Management Priorities," and require compliance examiners to follow the existing guidelines contained in the DCA Compliance Examination Manual.	March 31, 1999	Copy of the memorandum to all staff superceding the January 1998 Policy Memorandum 6410.14, "Risk Management Priorities."	NA	YES
2	DCA will supercede Policy Memorandum 6410.14, entitled "Risk Management Priorities," and require compliance examiners to follow the existing guidelines contained in the DCA Compliance Examination Manual.	March 31, 1999	Copy of the memorandum to all staff superceding the January 1998 Policy Memorandum 6410.14, "Risk Management Priorities."	NA	YES
3	DCA will supercede Policy Memorandum 6410.14, entitled "Risk Management Priorities," and require compliance examiners to follow the existing guidelines contained in the DCA Compliance Examination Manual.	March 31, 1999	Copy of the memorandum to all staff superceding the January 1998 Policy Memorandum 6410.14, "Risk Management Priorities."	NA	YES
4	DCA will separately identify and evaluate the risk areas related to the detection of noncompliance in banks and DCA's ability to meet examination frequency requirements.	March 31, 1999	Copy of the revised 1999 DCA Management Control Plan submitted to Office of Internal Control Management.	NA	YES
5	DCA will re-evaluate the risk ranking level for the DCA supervision and regulation accountability unit in the fourth quarter 1999 for the year 2000 Management Control Plan submission.	Fourth Quarter 1999	Copy of the DCA Year 2000 Management Control Plan.	NA	YES