

Office of Inspector General



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Audit Report No. 01-016

**Audit of DOS's Use of Expanded and
Impact Examination Procedures in the
Risk-Focused Examination Process**



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DATE: March 30, 2001

MEMORANDUM TO: Michael J. Zamorski, Acting Director
Division of Supervision



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SUBJECT: *Audit of DOS's Use of Expanded and Impact Examination Procedures in the Risk-Focused Examination Process (Audit Report 01-016)*

The Federal Deposit Insurance Corporation (FDIC) Office of Inspector General (OIG) has completed the third in a series of audits addressing various aspects of the Division of Supervision (DOS) risk-focused examination process. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of the financial institution while focusing resources on the institution's highest risks. In conjunction with the Federal Reserve Board, the FDIC has developed automated Examination Documentation (ED) modules to provide examiners a tool to focus on risk management and to establish guidelines for an appropriate examination scope, approach, and examination program, including workpaper documentation. Examination procedures within the ED modules are separated into three distinct tiers of review: core, expanded, and impact analysis.

This report presents the results of the OIG's audit of DOS's use and documentation of expanded and impact examination procedures in the risk-focused examination process. In our review of examination workpapers, we determined that, for the most part, examiners completed core analysis procedures and answered core analysis decision factors. However, in over one-half of the examinations we reviewed, we found that DOS examiners did not document the ED modules' expanded and impact analysis sections. Although examiners told us that they had performed the prescribed expanded analysis procedures or that they had performed alternative procedures, in most cases examiners did not use the ED modules developed by DOS to document the review performed. Furthermore, the examination files we reviewed did not always contain alternate forms of documentation summarizing the expanded and impact work performed in high-risk areas.

In discussing the audit results, DOS's senior management told us that they believe the Report of Examination itself constitutes adequate documentation of the work performed and provides the basis for conclusions reached. Furthermore, DOS officials have expressed that the Report of Examination has been, and is expected to continue to be, the primary basis and support for legal proceedings. The *DOS Manual of Examination Policies* (Manual) supports this statement by recognizing that the Report of Examination generally serves as the FDIC's primary evidentiary exhibit in formal administrative actions. The Manual also provides specific guidelines for the preparation of a report where the examiner believes formal administrative action is or may be warranted.

While the OIG recognizes that the Report of Examination is a form of documentation, we believe that it does not meet the intent of DOS's workpaper policy. In particular, the Manual states that workpapers "should provide written support for examination and verification procedures performed and the assertions of fact or opinion in the financial schedules and narrative comments in the report of examination." The Manual allows this requirement to be satisfied through the use of the ED modules.

We believe it is especially important for the workpapers to provide an adequate record of (1) examination work performed and (2) the basis and support for examiner conclusions, since these documents and conclusions are the written basis of support for the Report of Examination, for the institution's rating, and for decisions made during the examination. The examination function plays a key role in providing the FDIC the ability to maintain public confidence in the integrity of the banking system and in individual insured institutions. Given the significance and importance of this role, we believe good business practices and sound internal control systems would indicate that workpaper documentation standards should be designed to ensure that examiners consistently record the work they perform and provide support for conclusions they reach in bank examinations. DOS officials stated that the ED modules provide guidance for the examination process and are to be used as a documentation tool, and that a great deal of flexibility exists in how this tool is to be used. DOS officials believe that when the documentation requirements become mandatory, examiner judgment is reduced and the documentation burden becomes greater than its worth.

We recognize that examiner judgment plays a part in determining the depth of review needed in the various areas of a bank examination, and this audit did not challenge or question that judgment. Rather, this audit focused on determining the extent to which DOS examiners used and documented expanded and impact analysis procedures for high-risk areas in safety and soundness examinations. Specifically, we reviewed examinations where the banks had weak performance in one or more of the six components of an institution's financial condition and operations rated for safety and soundness purposes, namely, Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS). Sometimes this examination work resulted in adverse bank ratings with recommended enforcement actions and/or increased deposit insurance premiums.

The results of our audit showed that DOS has made progress in implementing the risk-focused examination process, especially in the area of core analysis. Nevertheless, as

detailed in this report, opportunities exist to further improve the effectiveness of the risk-focused examination program in the areas of expanded and impact analysis, examination planning, and post-examination analysis.

BACKGROUND

In October 1997, the FDIC, in conjunction with the Federal Reserve Board and the Conference of State Bank Supervisors, began implementing a new risk-focused examination process designed to focus safety and soundness examinations on bank functions that pose the greatest risk exposure. Under this risk-focused approach, examiners target examination resources on the areas of greatest risk within the bank, thereby increasing the effectiveness of the examination process without requiring increased resources.

The risk-focused examination process attempts to assess an institution's risk by evaluating bank management's ability to identify, measure, monitor, and control risk. Internal audits, external audits, loan reviews, and other control activities are integral to a bank's own assessment of its risk profile. The risk-focused examination process seeks to strike a balance between evaluating the condition of a bank at a certain point in time and evaluating the soundness of the bank's processes for managing risk. The risk-focused approach may involve less regulatory burden by testing, rather than duplicating, the work of audit and management review functions.

ED Modules

To ensure consistent application of the risk-focused examination process nationwide, DOS developed the ED modules to provide examiners with a tool to focus on risk management and to establish an appropriate examination scope. The ED 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. At the time that the examinations in our review were performed there were 10 Primary modules that examiners needed to address at every examination and 7 Supplemental modules that addressed specialized areas such as international banking and credit card lending.¹ Supplemental modules are used only when a bank engages in the subject activity. Each module contains a series of examination procedures for examiners to consider when evaluating an institution's risk. The use of the Primary and applicable Supplemental modules is mandatory at every DOS safety and soundness examination.

The extent to which an examiner works through each of the three levels of the ED modules (core, expanded, and impact) depends upon conclusions reached regarding the presence of significant concerns or deficiencies. The core and expanded sections of the ED modules consist of procedures to be performed, when applicable, and decision factors to be answered and supported. The impact analysis section reviews the impact that deficiencies identified in the core and expanded analysis and decision factors have on the bank's overall condition. The impact analysis section also directs examiners to consider

¹ In March 2000 DOS added an eighth Supplemental module relating to Securitization activities.

possible supervisory options. The impact analysis section of the ED modules does not include decision factors. When significant deficiencies or weaknesses are noted during the core analysis review, examiners are required to complete the expanded analysis for the areas that present the greatest degree of risk to the institution. If the risks are material or the activity is not adequately managed, examiners are expected to perform the impact analysis to assess the financial impact and to determine whether any enforcement action may be necessary. Appendix I is an example of one ED module, Earnings, showing the related core, expanded, and impact analysis procedures, and the core and expanded analysis decision factors for which the examiners must document the basis for the conclusions reached.

It is important to note, for purposes of the discussions that follow, that the Manual requires that examination workpapers provide written support for examination and verification procedures performed and provides that this requirement can be satisfied through the use of the ED modules. Other DOS guidance in the form of Regional Directors Memoranda includes provisions related to expanded work in examinations. The policy guidelines do not explicitly require examiners to use the ED modules to document their expanded work.

Bank Performance Ratings

Bank examinations provide examiners with an understanding of the nature, seriousness and cause of a bank's problems, and a factual foundation upon which to base corrective measures, recommendations, and instructions. The bank examination assesses six components of a bank's performance – Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. These components combine to form the CAMELS rating system, which includes a rating for each component and an overall composite CAMELS rating. Each CAMELS element and the composite is rated on a five-point scale, with a rating of "1" indicating the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and the least supervisory concern. Conversely, a rating of "5" indicates the most critically deficient performance and risk management practices relative to the institution's size, complexity, and risk profile, and the greatest supervisory concern.

OIG Reviews of the Risk-Focused Examination Process

This is the third in a series of OIG audits related to the risk-focused examination process. The first audit report was issued on November 5, 1998 and was entitled *Audit of Implementation of the Risk-Focused Examination Process* (Audit Report No. 98-086). This audit assessed DOS's initial implementation of the process, and the audit results showed that while DOS recognized the need to develop a nationwide risk-focused examination process, the field offices were not implementing the process as intended by DOS headquarters management.

The OIG issued a second report on May 5, 2000 entitled *Follow-up Audit of the Implementation of the DOS Risk-Focused Examination Process* (Audit Report No. 00-016) (Follow-up Audit). This audit assessed the overall progress DOS had made in implementing

the risk-focused examination approach. The OIG concluded that DOS had made progress; however, there were still some aspects of the process that could have been improved. One finding, in particular, noted that examiners in some of DOS's field offices were not always using the expanded analysis procedures as intended for components that were deemed to be higher risk areas (rated "3," "4," or "5"). In addition, this finding was based, in part, on a limited review of seven examination files for banks that were rated "3," "4," or "5."

During the OIG's presentation of the Follow-up Audit report to FDIC's Audit Committee in June 2000, Committee members asked several questions related to the audit finding concerning the examiners' use of expanded analysis procedures. This report responds to the Committee's inquiries as they relate to the objective of our audit, namely, to determine the extent to which DOS examiners use and document expanded and impact analysis procedures for high-risk areas in safety and soundness examinations of institutions.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our audit objective was to determine the extent to which DOS examiners used and documented expanded and impact analysis procedures for high-risk areas in safety and soundness examinations. For purposes of this audit, "high-risk" areas constitute any of the six components of a bank's operations that received a rating of "4" or "5." To address our audit objective, we focused on the examiner's documentation of expanded and impact analysis procedures in the form of ED modules. One of the Primary modules, Risk Scoping Activities, does not contain expanded and impact analysis sections. We also reviewed the planning, core analysis, and post-examination activities to determine the extent to which expanded and impact analysis might have been addressed in these activities. We did not evaluate the content within the Reports of Examination, and we did not question or challenge the composite or component CAMELS ratings assigned by the examiners for the bank examinations we reviewed. We also did not assess the adequacy of the core, expanded, or impact analysis procedures contained in the ED modules; rather, we accepted the ED modules and related procedures as DOS's prescribed approach to bank examinations.

To accomplish our audit objective, we:

- Reviewed original examination workpapers documenting the results of all 42 bank examinations initiated during the period October 1, 1999 through March 31, 2000 with at least one CAMELS component rating of "4" or "5." The 42 examinations were conducted by examiners in 29 field offices in all eight regions and included 78 components that received a rating of "4" or "5."
- Interviewed 11 Examiners-in-Charge for 11 of the 42 examinations reviewed. These examiners were from three regions: San Francisco, Chicago, and Memphis.
- Interviewed 5 Field Office Supervisors, 6 Case Managers, and 10 other regional office personnel.
- Interviewed management officials in DOS Headquarters.
- Reviewed the risk-focused examination modules, instructions, and other guidance to examiners related to risk-focused examinations.

- Reviewed DOS internal review reports.
- Reviewed and analyzed training material for the “Risk-Focused Supervision Refresher Training Course” presented to examiners during 2000.
- Reviewed corrective actions for two recommendations from a previous OIG audit related to guidance for ED modules.

We performed fieldwork in DOS headquarters; the San Francisco, Chicago, and Memphis Regional Offices; and five field offices located in the three regions. We conducted our audit in accordance with generally accepted government auditing standards. The audit fieldwork was conducted from mid-April 2000 through mid-October 2000. We held an exit conference with DOS management in October 2000 to discuss the results of our audit. DOS management comments obtained at the exit conference are reflected in this report.

RESULTS OF AUDIT

DOS continues to make progress in implementing the risk-focused examination process. Training and guidance have helped clarify the process as it relates to core analysis. In our review of examination workpapers, we found that, for the most part, examiners completed core analysis procedures and answered core analysis decision factors. However, more needs to be done in the areas of expanded analysis and impact analysis.

Specifically, our review of workpapers for 42 examinations conducted by examiners in the eight DOS regional offices showed that examiners are using and documenting expanded procedures in the form of ED modules only to a limited extent. We also found that examiners’ use and documentation of the impact analysis procedures is limited. Although our audit focused on the use and documentation of expanded and impact analysis procedures, we also looked at pre-examination planning and post-examination activities documented in the 42 examination workpaper files we reviewed. We found that most examiners were not addressing in Scope Memoranda the need to perform expanded procedures for areas perceived as high-risk based upon information acquired during the pre-examination analysis phase, and that Scope Memoranda did not include a discussion of a significant number of the ED modules. With respect to post-examination activities, we found that a national requirement for post-examination analysis does not exist.

We are recommending additional steps that DOS can take within each phase of the examination process namely, pre-examination planning, examination performance, and post-examination analysis, to help ensure full implementation and complete management support of the risk-focused examination process. In concert with the theme of full implementation of the risk-focused examination process, we are recommending that DOS require and ensure that examiners use expanded and impact analysis sections of the ED modules to document work performed in high-risk areas and that DOS clarify the language in existing guidance regarding the use and documentation of expanded and impact analysis procedures. We are also recommending that DOS examiners identify and discuss in the pre-examination planning memoranda the Primary and Supplemental ED modules and the applicability of expanded analysis for potential high-risk areas. DOS

also needs to emphasize the role of regional and field office personnel in ensuring complete implementation of the risk-focused examination process and develop a national requirement for post-examination analysis. Taken together, these recommended actions should strengthen the entire risk-focused process, from pre-examination planning through examination performance to post-examination analysis, and provide benefits for future examinations. Our report also reflects a number of best practices from four DOS Regional Offices.

FULLER USE OF THE EXPANDED AND IMPACT ANALYSIS SECTIONS WITHIN THE ED MODULES WOULD STRENGTHEN THE RISK-FOCUSED EXAMINATION PROCESS

Based on our review of examination workpapers for 42 institutions whose ratings included a CAMELS component rating of “4” or “5,” we found that examiners were generally not using the expanded and impact analysis sections of the ED modules to document expanded and impact procedures. The Manual requires that examination procedures and conclusions be sufficiently documented in the workpapers and allows this requirement to be satisfied through the use of the ED modules. Examination documentation requirements have been further communicated in a March 23, 1999 Regional Director Memorandum, entitled *Risk-Focused Examination Program – Documentation Requirements*, stipulating, in part, that when significant deficiencies or weaknesses are noted, examiners are required to complete the expanded analysis for the areas that present the greatest degree of risk to the institution. If the risk is material or the activity is not adequately managed, then examiners are also expected to perform an impact analysis. Based on discussions with DOS senior management, while examiners are expected to perform the appropriate expanded analysis procedures as needed, policy guidelines do not require the examiners to document their review and analysis via the ED modules. Furthermore, policy guidelines do not stipulate how the impact analysis should be documented, if at all. We address the need to provide guidance on documenting expanded and impact analyses later in this report.

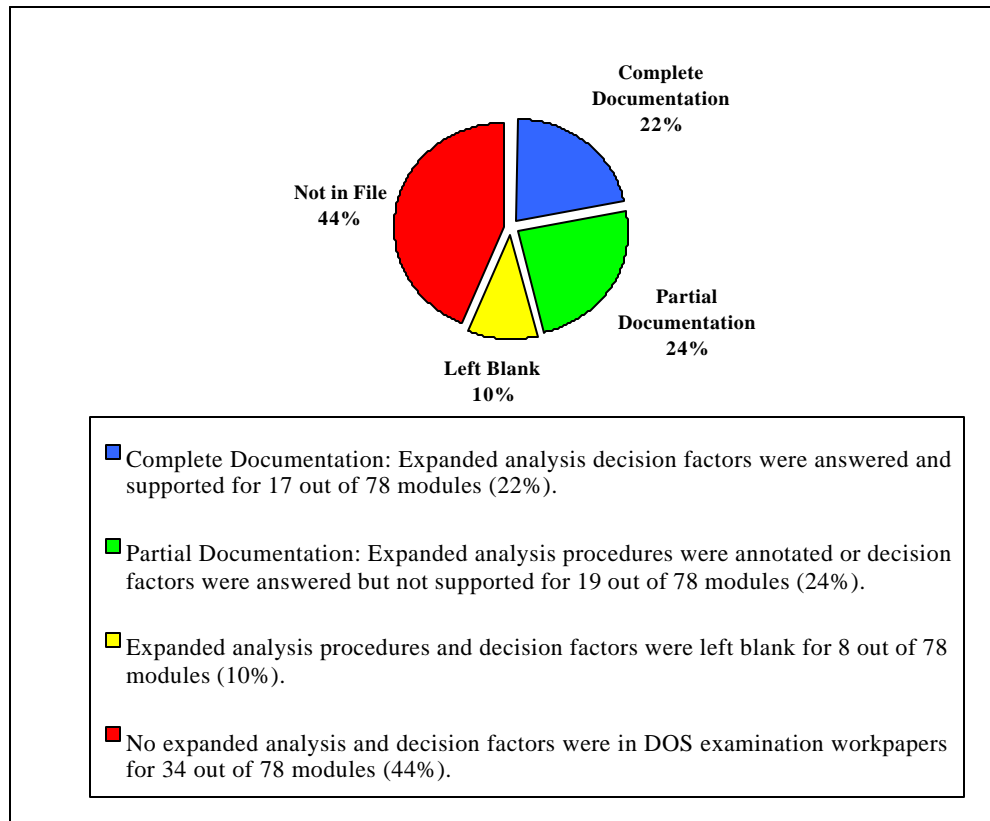
Expanded Analysis

Our review determined that 22 percent of the modules we reviewed had complete documentation in which the expanded analysis decision factors in the ED modules were answered and supported. However, some examiners are not documenting the expanded analysis section. As illustrated in Figure 1, of the 42 examinations we reviewed, the majority of examiners did not document an expanded review in the form of the ED modules for the 78² rating components that were deemed to be high-risk areas (rated “4” or “5”). When the expanded analysis section was documented, some examiners only

² The Asset Quality component factor has three ED modules associated with it (Loan Portfolio Management and Review: General, Securities Analysis, and Other Assets and Liabilities). For purposes of this review we selected the module that was documented most fully to represent the level of documentation for the Asset Quality component. This selection impacted 11 examinations and resulted in disregarding the data that was recorded for 22 modules.

provided partial documentation in which expanded analysis procedures were annotated or expanded analysis decision factors were answered but not supported.

Figure 1: Use of the Expanded Analysis Sections Within the ED Modules



We interviewed Examiners-in-Charge for 11 of the 42 examinations reviewed; four of the examiners completed the ED modules, and seven did not. The examiners that did not complete the ED modules assured us that the work had been performed; however, the nature or extent of the work was not evident in the workpapers in the form of the ED modules. The examiners provided the following reasons for not using the ED modules to document their work:

- A higher list of priorities existed and a sufficient amount of time was not available to document all of the required tasks,
- The expanded analysis procedures within the management module did not correlate to the core analysis concerns,³ and
- A lack of understanding and familiarity with the documentation requirements existed. (Similar to the prior audit findings within the Follow-up Audit report, some examiners were uncertain as to what degree of response was needed to

³ While we did not analyze the content of the ED modules, management may want to consider this observation in its next review of the ED modules.

support a conclusion, and when and how targeted expanded procedures should be implemented.)

Furthermore, the majority of Examiners-in-Charge stated that they do not typically review examiners' workpapers to ensure the adequacy of documentation.

In the absence of ED module documentation, we looked for alternative workpapers that would serve as documentation for the expanded and impact work performed and for the basis and support for examiner conclusions. From our universe of 42 bank examinations, we reviewed the examination workpapers of the 11 examinations that had a composite (overall) rating of "4" or "5" and that had ED module documentation missing within the expanded and impact analysis sections on the components that were rated a "4" or "5." Specifically, we looked for documentation such as a brief summary of procedures performed, a memorandum to the file explaining the procedures performed and the basis for the conclusions reached, or any similar document providing written support for examination and verification procedures performed. We found summaries of expanded and impact procedures performed in the form of memoranda to the file for only one of the 11 examinations. In all 11 examinations, the respective Reports of Examination included discussions of the subject areas.

For the 10 examinations where the ED module documentation was absent and we could not locate evidence of alternative workpapers in the files, we reviewed the Reports of Examination to determine whether the bases for the "4" and "5" component ratings were impacted by the concerns identified in other subject areas. The purpose of our additional review was to determine whether the examiners' conclusions for these components were documented in workpapers for other components.

As an example, one financial institution was rated a "4" in Asset Quality and Management and a "5" in Earnings. By reviewing the Report of Examination for this institution, we determined that the main concerns the examiners identified were within the bank's loan portfolio. Specifically, the examiners raised concerns about the volume of adversely classified assets, subprime lending activities, and loan administration and credit review. As a result of the poor asset quality, the bank experienced 2 years of net losses that the examiners directly attributed to management's lending practices. The examiners reported that Management was inadequate, due in part, to those concerns identified within Asset Quality and Earnings. In this example, the examiner documented expanded procedures within the "Loan Portfolio Management and Review: General Module" as well as the "Loan Reference Module" on subprime lending. As a result, supplemental documentation existed that contributed to formulating the examiners' conclusions and ratings for other components; however, this supporting documentation did not fully illustrate the procedures and analysis performed in those other subject areas.

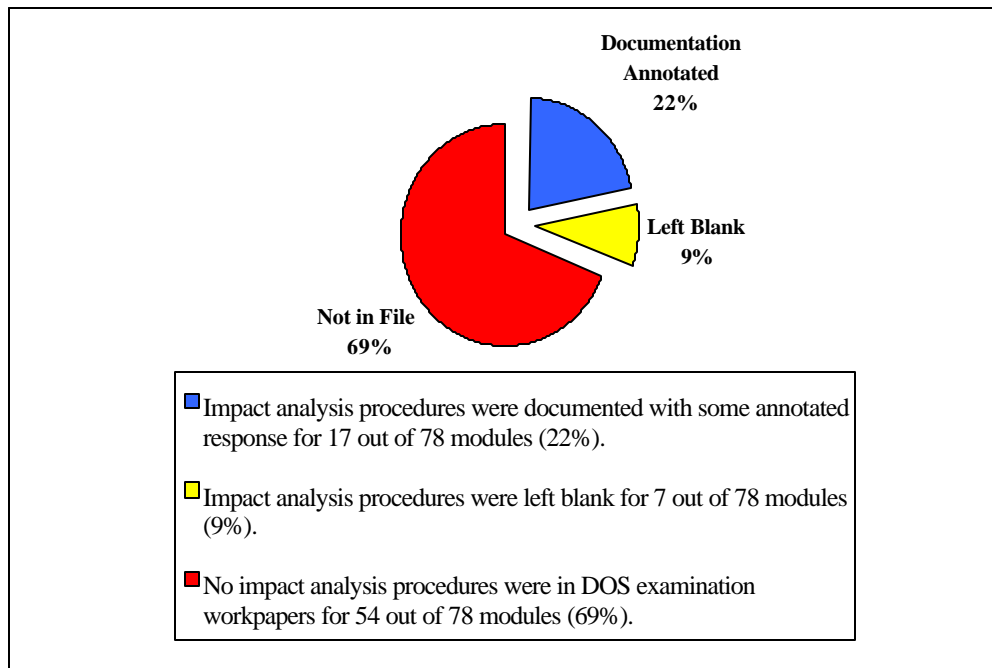
For 5 of 10 examinations, we found that related procedures were documented in other subject areas that correlated to the main concerns identified within the Report of Examination. While we recognize that this supplemental documentation could be viewed as a form of support for the conclusions reached in the other subject areas, the existence

of this support does not preclude the examiner from using the DOS prescribed ED modules or from completing the expanded and impact analysis sections of the ED modules. For the remaining 5 examinations, no related procedures were documented in the other subject areas.

Impact Analysis

We determined that examiners are not using the impact analysis section. Of the 42 examinations we reviewed, the majority of examiners did not document impact review procedures in the form of the ED modules for the 78 sections that were deemed to be higher risk areas (rated “4” or “5”). Figure 2 shows that examiners documented impact analysis for only 22 percent of the high-risk areas in the examinations that we reviewed.

Figure 2: Use of the Impact Analysis Sections Within the ED Modules



Seven of the 11 Examiners-in-Charge we interviewed were not familiar with the terminology and pertinence of the impact section of the ED modules. Some were not familiar with the term “Impact Analysis,” and some were not familiar with the type of procedures contained within the section. However, out of the 11 Examiners-in-Charge that we interviewed, nine examiners assured us, in part, that proper consideration would have been given, when deemed necessary, to the bank’s overall condition and to the need for supervisory action.

We discussed our observations related to the expanded and impact analysis with DOS management during our exit conference on October 11, 2000. DOS management agreed that examiners should complete the expanded and impact analysis section of the ED modules for high-risk areas. However, management later stated that the documentation

of the impact analysis did not add any value to the examination process. DOS management believes that the impact analysis merely provides guidelines for those examiners who are not familiar with how the impact of one area can affect other areas and the bank's overall condition. Furthermore, management stated that in a situation of significant supervisory concern, the impact on other areas and the overall condition would be evident in the Report of Examination and the assigned ratings. Management also feels that requiring additional documentation would not strengthen the examination process, but would actually delay the initiation of possible enforcement action as the examination process would be elongated.

We believe that adequate documentation standards are an essential component to the internal control process, help ensure that management's directives are carried out, and facilitate supervisory and quality assurance reviews. Although the Manual allows examiners to use the ED modules to satisfy workpaper documentation requirements, nationwide guidance does not require the examiners to use the ED modules to document expanded and impact procedures or analyses performed. The Memphis Regional Director issued guidance on the use and documentation of the ED modules on June 26, 2000 that mandates the use of the ED modules at every safety and soundness examination in the Memphis region and delineates the circumstances in which examiners are expected to use and document the expanded and impact analysis sections of the ED modules. This guidance requires examiners to:

- Document examination procedures and analyses in the ED software,
- At a minimum, complete the core analysis decision factors for each Primary module,
- Complete the expanded analysis procedures for the areas that present the greatest risk to the institution,
- Document expanded analysis procedures performed for any "3" component rating, or for any institution with a composite-rating of "3," "4," or "5," and
- Complete and document the impact analysis when the risks identified during the core and expanded analyses are material.

Recommendation

We support the Memphis Regional Office guidance and agree that examiners should use the ED modules to document their extended work. Accordingly, we recommend that the Director, DOS:

- (1) Require and ensure that examiners use the expanded and impact analysis sections of the ED modules to document work performed in areas with significant deficiencies or weaknesses.

CLARIFYING EXISTING POLICIES AND GUIDANCE ON EXPANDED AND IMPACT ANALYSIS EXAMINATION PROCEDURES WOULD HELP EXAMINERS

DOS needs to clarify its existing guidance related to ED modules in order to provide examiners clear, definitive direction on what constitutes adequate documentation of expanded and impact analyses in the examination workpapers. DOS has issued national guidance regarding the use and documentation of the ED modules. These guidelines are included in the Manual and various divisional memoranda, and DOS has reinforced existing guidance through its risk-focused supervision refresher training course provided to examiners. However, DOS's guidance contains conflicting requirements regarding how to document the expanded analyses. Furthermore, the existing guidance does not require examiners to document impact analyses in the examination workpapers.

Guidance Related to Use and Documentation of Expanded and Impact Analysis Procedures

DOS issued a Regional Directors Memorandum entitled, *Risk-Focused Examination Process – Program's Goals and Objectives*, dated December 16, 1998, that mandated the use of the ED modules at every safety and soundness examination. A subsequent DOS Regional Directors Memorandum entitled, *Risk-Focused Examination Program – Documentation Requirements*, dated March 23, 1999, states that, when significant deficiencies or weaknesses are noted in the core analysis review, examiners are required to complete⁴ the expanded analysis review for the areas that present the greatest degree of risk to the institution. The March 1999 Regional Directors Memorandum also stipulates that examiners are expected to perform the impact analysis if risks are material or the activity is not adequately managed. The Manual also includes the requirement for expanded analysis when significant weaknesses are noted during the core review and impact analysis if the risks are material or the activity is inadequately managed.

Although DOS has guidance requiring the use of ED modules in examinations, the guidance does not specifically require the use of the ED modules to document expanded analysis procedures performed. Furthermore, the DOS guidance we reviewed did not include any requirements for documenting the review and results of the impact analysis. During our exit conference on October 11, 2000, DOS management informed us that the purpose of the previously referenced regional memoranda issued in December 1998 and March 1999 was to provide flexibility to examiners in meeting the workpaper preparation requirements specified in the Manual. According to DOS management, DOS issued its December 1998 guidance to ease the workpaper requirements because DOS management wanted examiners to have more time to become better acquainted with the risk-focused approach to examinations and the core analysis section of the ED modules. DOS issued

⁴ DOS policy officials stated that the policy's intent was to require examiners only to "perform" the necessary procedures and not necessarily to "complete" them. They clarified that the word "perform" implies that an individual would be required only to carry out certain tasks, while the word "complete" implies that a comprehensive effort of the entire process would be required that encompasses the performance and documentation of those certain tasks.

the March 1999 guidance to provide more flexibility to examiners in completing ED modules to assist in meeting the demands of Year 2000 (Y2K) readiness workload.

DOS management told us that the December 1998 and March 1999 memoranda were intended to provide interim guidance for the time period in which examiners would be experiencing the competing demands of performing examinations while focusing on supervisory Y2K concerns within the banking industry. We acknowledge DOS's intention to ease the new ED module documentation requirements at the time that DOS's workload was significantly increased due to the Y2K readiness concerns. However, since the Y2K workload has been completed, we believe that the temporary ED module guidelines are no longer needed. We believe that DOS should now issue guidance to clarify what constitutes adequate documentation of expanded and impact analysis procedures in bank examination workpapers.

Training Provided

DOS provided Risk-Focused Supervision refresher training to its examiners during calendar year 2000. The objectives of the training included clarifying goals and objectives of the risk-focused process, stressing the importance of proper risk scoping, and refreshing examiners' understanding of risk-focused examination procedures. We attended the training and noted that the course addressed the use of the ED modules and documentation requirements, principally in the area of core analysis and core decision factors. This type of refresher training could be beneficial in the future to focus on expanded and impact analysis procedures and to communicate to examiners DOS management's expectations on what constitutes adequate documentation in these areas.

Recommendation

We believe DOS's existing guidance specified in the December 1998 and March 1999 regional memoranda needs to be modified to provide examiners clear direction on when and how expanded and impact analysis procedures should be performed and documented in examination workpapers. We recommend that the Director, DOS:

- (2) Clarify existing guidance on how expanded analysis procedures and impact analysis procedures should be documented in examination workpapers.

INCLUDING EXAMINATION STRATEGY FOR PERCEIVED HIGH-RISK AREAS IN THE SCOPE MEMORANDUM WOULD STRENGTHEN THE RISK-FOCUSED PLANNING PROCESS

DOS's March 1999 Regional Directors Memorandum stipulates, in part, that the Examiner-in-Charge is responsible for developing an examination plan that is commensurate with the level of risk in each functional area and for documenting this plan in a "Scope Memorandum." The guidelines state that, for each Primary and applicable Supplemental module, the Scope Memorandum should justify decisions to limit procedures with a paragraph or a descriptive set of comments that explain the reasons for the limited review. In addition, DOS management stated in its December 1998 guidance that the pre-examination planning process and the Scope Memoranda are crucial to the effective and efficient use of the risk-focused examination program. Furthermore, as noted within the Risk Scoping Activities module, scope memoranda should include the following information:

- Summary of pre-examination meeting.
- Summary of audit and internal control environment.
- Preliminary risk assessment addressing CAMELS components.
- Summary of examination procedures. Include a discussion of the modules to be completed and the depth of coverage in different areas.
- Summary of anticipated loan review.
- Examination staffing.

DOS's March 1999 guidelines do not require examiners to formulate, justify, or document decisions to perform expanded procedures. DOS management told us that the pre-examination planning process and the Scope Memorandum were never envisioned to be used as vehicles to identify and document the need to perform expanded work in a particular area of a bank's operations. Rather, DOS management believes that the risk-scoping process should be primarily focused on identifying areas that are deemed to be well-controlled or that pose minimal risk to the institution and that can be reviewed on a limited basis. Accordingly, the Scope Memorandum is a mechanism for the Examiner-in-Charge to document decisions to limit procedures and provide reasons for the limited review. DOS management stated that the decision to actually use expanded procedures is made during the examination process and is predicated upon the results of the core procedures/decision factors. As a result, DOS management feels that any additional documentation requirements for the Scope Memorandum would be duplicative and burdensome for the examiners.

We believe the Scope Memorandum could be a more effective and valuable planning tool if it would include information regarding known high-risk areas and identify the extent of review needed. A Scope Memorandum that identifies areas requiring little or no work as well as areas expected to warrant greater emphasis would provide examination team members, Field Office Supervisors, Case Managers, and other regional management more complete information to help evaluate scoping decisions and resource planning for

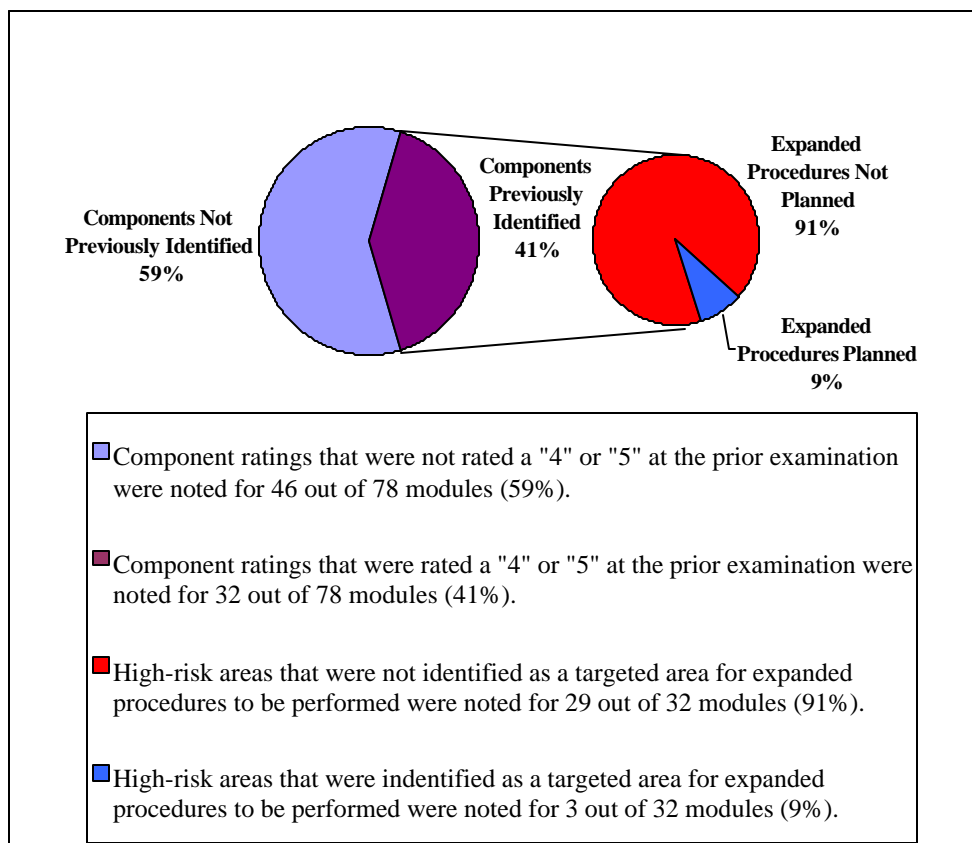
an examination. This type of Scope Memorandum would also be a more effective means of achieving the objectives to: (1) present a bank examination plan “commensurate with the level of risk in each functional area” as required by DOS’s March 1999 Regional Directors Memorandum and (2) provide a discussion of “the modules to be completed and depth of coverage in different areas” as stipulated in the Risk Scoping Activities module. The preliminary identification of high-risk elements and the corresponding depth of review would not hinder the flexibility available to examiners to change the scope of review during the examination process. Similarly, an area that was identified during the pre-examination process for receiving a limited review should not be restricted from further review if subsequent information became available during the examination.

We reviewed the Scope Memoranda for each of the 42 examinations in our universe and found that most of the examiners were not addressing the need to perform expanded procedures for areas perceived as high-risk based upon information acquired during the pre-examination analysis phase. We also found that Scope Memoranda did not include a discussion of a significant number of the ED modules. In addition, we found that the role of supervisory personnel during the planning process could be further emphasized.

Identification and Discussion of Expanded Procedures

Pre-examination planning can help set scope decisions in terms of work to be performed and areas to receive special attention. Pre-examination planning culminates with a Scope Memorandum intended to discuss the examination strategy. The Scope Memoranda we reviewed seldom identified the perceived high-risk areas for which expanded analysis procedures should have been implemented. For those subject areas that received a “4” or “5” component rating, only 9 out of 78 modules (12 percent) were targeted in the Scope Memoranda during the scoping process for the implementation of expanded procedures. Since all high-risk areas may not be evident in preplanning, we reviewed the previous examinations’ ratings for the 78 modules that received a “4” or “5” component rating in our sample of reports. We believed these areas would be identified as “high risk” and would require more attention during the examination. We found that 32 of the elements (41 percent) had been rated a “4” or “5” at the last examination. Figure 3 shows that 29 of the 32 components (91 percent) were not identified in the Scope Memoranda for our sample as perceived high-risk areas needing an expanded review.

Figure 3: Use of Pre-Examination High-Risk Indicators



Some of the Examiners-in-Charge we interviewed told us that the identification and determination to perform expanded procedures would only be made after the core analysis procedures were initiated. Other examiners did not correlate the risk identified during the pre-examination process with the need to perform expanded procedures. The majority of Case Managers and Field Office Supervisors we interviewed stated, in part, that their review comments, whether oral or written, concerning the planned scope of the examination are not made in the context of the ED modules.

Discussion of the ED Modules

The Scope Memoranda we reviewed did not always address all Primary and Supplemental modules. Of the nine Primary modules for the 42 examinations reviewed, the examiners provided a written discussion on 282 out of 378 modules (75 percent). Of the seven Supplemental modules, examiners provided a written discussion on 116 out of 294 modules (39 percent). For review purposes, a written discussion was deemed to have occurred if, at a minimum, the module or its subject area was either noted as not being applicable, or the subject area was referenced with an indication that the ED modules would be used. During interviews with 11 Examiners-in-Charge, some of the examiners

provided the following reasons for not including a written discussion of the Primary or Supplemental ED modules in the Scope Memoranda:

- The omissions were just oversights,
- The omissions were in less significant areas,
- When only the subject area was discussed in the Scope Memorandum, examiners assumed that it implied that the core module would be performed, and
- When a subject area was not discussed in the Scope Memorandum, examiners assumed that the lack of discussion implied that the subject area was not applicable.

As noted earlier, most of the supervisory personnel, six Case Managers and five Field Office Supervisors, we interviewed told us that their comments, whether oral or written, concerning the planned scope of the examination are not made in the context of the ED modules.

During our exit conference on October 11, 2000, DOS management said that the pre-examination planning process and Scope Memoranda were not intended to identify and document the need to perform expanded procedures. Furthermore, requiring examiners to determine and support the need to perform expanded procedures within the Scope Memorandum would duplicate the existing examination process and would be burdensome. However, we would anticipate that examiners would only need to identify their intention to perform expanded procedures when high risks are apparent and that an extensive level of justification and documentation is not expected at that point in the process.

DOS management also stated that when the Scope Memoranda did not discuss certain modules, the lack of discussion implied that those modules were either not applicable to the bank being reviewed, were applicable but not material, or that the core analysis section would be completed. Furthermore, DOS management makes a distinction between Primary and Supplemental modules. In particular, all nine Primary modules are to be completed under normal guidelines unless the Scope Memorandum specifically discusses the area and directs that a limited review be performed. Conversely, the Supplemental modules are only provided as a resource for examiners to use when that activity is a significant area of a bank's operation. DOS management also stated that it is not necessary to discuss Supplemental modules within the Scope Memorandum. However, we believe that in instances when a module is not identified or discussed, the Field Office Supervisor, Case Manager, or Assistant Regional Director may not know what level of review will be conducted and whether the module's absence is intentional or an oversight. As a result, we are concerned that if the examiner does not address particular elements within the Scope Memorandum, a comprehensive review of the institution may not be performed and the module's potential impact to the bank may not be considered in the institution's assessment.

We recognize that DOS has instructed its examiners to provide direction to examination staff through the Scope Memorandum if the review of a selected area is to be limited due

to minimal perceived risks. We believe this instruction should also apply to examiners providing direction to examination staff through the Scope Memorandum if the review of a selected area is to be expanded due to maximal perceived risks. Appropriately planning an examination helps provide an identification of an institution's key risk areas and tailor examination activities to the bank's unique risk profile. The pre-planning process can be used to establish and justify budgeted hours and to focus and prioritize the initial review efforts of examination personnel.

As we reported in our Follow-up Audit, we support the New York Regional Office's actions in developing a pre-planning report format that provides comprehensive guidance to examiners to help achieve consistency and completeness in preparing Scope Memoranda. DOS management may want to consider using the pre-planning guidance issued by the New York region as an example of "best practices" for other regions to follow. The New York Regional Office Memorandum, *Pre-examination Planning Memoranda and Post-Examination Tracking Reports*, dated January 11, 2000, requires that the Pre-examination Planning Memorandum address each module, provide the respective scope of review (limited, full, or expanded), and include the justification for the depth of review chosen.

Recommendations

We recommend that the Director, DOS:

- (3) Require examiners to identify and discuss within the Scope Memoranda the need to perform expanded procedures when the results of the pre-examination reviews indicate that potential areas of significant deficiencies or weaknesses are present.
- (4) Require and ensure that examiners identify and discuss within the Scope Memoranda each Primary and Supplemental ED module for each examination.

Supervisory Reviews

During our audit we found varying levels of familiarity with the ED modules among the Case Managers and Field Office Supervisors. In addition, most supervisory personnel told us that their comments, whether oral or written, concerning the planned scope of the examination are not made in the context of the ED modules. As a result, examiners may not be fully encouraged to use the ED modules to document work performed and to implement the risk-focused examination process. By emphasizing the role of supervisory personnel, DOS would be better able to effectively capitalize on the supervisor's influence to ensure the implementation of the pre-examination planning process. We support the San Francisco Regional Director's actions in identifying, clarifying, and establishing the roles and responsibilities of the Case Managers and Field Office Supervisors/Supervisory Examiners (FOS/SEs) in relation to the pre-examination planning process. In particular, the San Francisco Regional Office Memorandum entitled, *Pre-examination Planning Guidance* dated March 30, 1999 provides, in part, that Case Managers and FOS/SEs are expected to be actively involved throughout the risk scoping and pre-examination planning process. Supervisory personnel are expected

to review and discuss with the Examiner-in-Charge the appropriateness of the chosen scope of the examination and of the chosen risk-focused examination procedures.

We discussed this issue with DOS management during our October 11, 2000 exit conference. DOS management stated that further emphasis on supervisory involvement in determining the need for expanded reviews and in ensuring the coverage of all modules during the pre-examination planning process was not needed. However, we believe supervisory personnel can play a significant role in ensuring the implementation of the pre-examination planning process. As recognized within the San Francisco regional guidance, Case Managers in particular, “have a unique perspective on the institution as they deal with the institution throughout the year, often having direct contact with management. Accordingly, they are a valuable resource to the EIC in the pre-examination planning process.”

Recommendation

We recommend that the Director, DOS:

- (5) Emphasize the role of Case Managers and FOS/SEs in ensuring the implementation of the pre-examination planning process which includes the initial identification and determination of the appropriate level of review to be conducted within the ED modules. In part, national guidance should be provided that communicates DOS’s expectations as to the goals, roles, and responsibilities of Case Managers and FOS/SEs within the pre-examination planning process.

INCORPORATING POST-EXAMINATION MEMORANDA INTO THE RISK-FOCUSED EXAMINATION PROCESS WOULD ENHANCE EFFECTIVENESS

Although not a nationwide requirement, six of the eight DOS regional offices prepare a Post-Examination Tracking Report (Post-Examination Memorandum) at the conclusion of the bank examination. One of the purposes of the Post-Examination Memorandum is to document scope changes that occurred during the examination compared to what was identified as the work to be performed in the Scope Memorandum. DOS regional management in Chicago views post-examination analysis as an opportunity for the Examiner-in-Charge to assess the efficiency of the examination and the effectiveness of the Scope Memorandum by comparing actual results to projections.

In our review of bank examination workpapers, we found Post-Examination Memoranda for 26 of the 33 examinations in our sample for the six DOS regional offices that prepare these memoranda. In some cases, although the Post-Examination Memorandum was prepared, the scope changes that transpired during the course of the examination were not specifically mentioned in the Post-Examination Memorandum. However, we did find several Post-Examination Memoranda in the examination workpapers that included a description of the limited or expanded scope of work or changes that had occurred from the planned work to what actually transpired. As an example, for one of the examinations in our sample, the Scope Memorandum indicated that only a standard

review would be performed for the Liquidity and Rate Sensitivity segments of the examination. In this example, the Examiner-in-Charge noted in the Post-Examination Memorandum that examiners had actually used expanded procedures to review the Liquidity and Rate Sensitivity areas because of risks identified in both areas during the onsite review. This is a good illustration of the examiner documenting the differences in planned and actual examination procedures, and providing reasons for variances from projected examination hours to time actually spent on the examination.

Two of the three regional offices we visited have issued written guidelines for performing post-examination analysis and for completing a Post-Examination Memorandum. The Chicago Regional Office issued its guidance in October 1998 and the Memphis Regional Office issued its guidance in April 1999. According to the Chicago Regional Office guidance, the post-examination analysis can be used as a learning tool with experiences applied to make future examinations more effective and efficient. We believe this is a valid expectation and an excellent use of the Post-Examination Memorandum. In addition to the Chicago and Memphis regions, the New York Regional Office issued a Regional Office Memorandum in January 2000 that modified the region's post-examination tracking procedures and instructed examiners to include in the Post-Examination Memorandum an explanation for deviations from the planned examination focus.

We support the regional attention being given to the need to complete a post-examination analysis of the bank examination and to use the analysis a source for effectively and efficiently planning future reviews of the institution. We believe that post-examination analysis completes the risk-focused examination process and provides final, helpful information that documents any significant changes that occurred during the examination process. Further, in planning or conducting subsequent examinations, examination staff can refer to the entire set of examination workpapers prepared for the previous examination and benefit greatly from the information contained therein.

We discussed the importance of post-examination analysis as a planning tool for future examinations with DOS management during our exit conference on October 11, 2000. DOS management expressed their reservations about burdening examiners with the task of preparing more examination documentation than the amount already required. DOS management told us that examiners may be reluctant to prepare post-examination memoranda due to time constraints and the perceived burden of already having to write a significant amount of narrative in scope memoranda and the ED modules. However, DOS management said they might be receptive to the concept of a national requirement for post-examination analysis as long as the narrative is kept to a minimum. We believe that post-examination analysis does not have to be burdensome. As indicated in the Chicago Regional Office guidance, the intent is for the examiner to prepare brief explanations and descriptions of variances from projections.

Recommendation

We recommend that the Director, DOS:

- (6) Develop a national requirement for post-examination analysis, including guidance for preparing and completing post-examination memoranda similar to the instructions issued by the Chicago Regional Office in October 1998.

CONCLUSION

In over half of the examinations we reviewed, DOS examiners did not document the ED modules' expanded and impact analysis sections in reviewing high-risk areas of a bank's operations. Examiners told us that they performed the expanded review; however, in most cases the work was not evidenced in the examination workpapers in the form of the ED modules or alternative workpaper documentation. Given the significance and importance of DOS safety and soundness examinations, we believe workpaper documentation standards should be followed to ensure that examiners consistently record their work and provide support for the conclusions they reach in bank examinations. DOS intended the ED modules to serve as this standard.

DOS's guidance on examination documentation requirements includes the following statement: "DOS senior management fully supports the risk-focused approach and expects the program to be fully implemented and supported at all management levels." We agree with this principle. Opportunities exist to further improve the risk-focused examination process and ensure its full implementation. As noted in our report, certain regional and field offices have already taken positive initiatives to enhance their risk-focused examination efforts. Through its training and guidance, DOS has made significant strides in conveying to examiners its expectations regarding the core analysis segment of the ED modules. Similarly, DOS needs to communicate to its examiners the importance of using and documenting the expanded and impact analysis sections of the ED modules for areas with significant deficiencies or weaknesses. DOS could also strengthen the entire risk-focused examination process through clarification of existing guidance and enhancements to its pre-examination and post-examination practices.

CORPORATION COMMENTS AND OIG EVALUATION

On March 13, 2001, DOS provided a written response to a revised draft of this audit report addressing each of the report's six recommendations. DOS's response, without its attachments, is presented Appendix II. DOS's response and its planned corrective actions provided the requisite elements of a management decision for all six recommendations in the report, as shown in Appendix III.

We issued our initial draft report to DOS on December 22, 2000, and a revised draft on January 26, 2001. The revisions were made to the draft report based on discussions with DOS, and included adding clarifying language primarily on DOS's current policy

regarding the Scope Memorandum. We also held several subsequent meetings with DOS.

In its response, DOS said it agreed with the thrust of the six recommendations and would take appropriate action to implement the recommendations. However, DOS noted that if all the recommendations were implemented in their entirety, in some cases considerable examiner time might be devoted to preparing additional, and possibly duplicative, workpaper documentation. DOS further noted that DOS's ongoing Process Redesign project involves a thorough assessment of the Division's supervisory processes with a goal of identifying ways to improve and streamline the processes. DOS stated that the recommendations and possible actions from the Process Redesign initiative might affect the policies and requirements for using ED modules. Accordingly, DOS has proposed in its response a few alternatives to some parts of the audit recommendations.

We want to emphasize that our intent is not to require unneeded amounts of documentation and especially not duplicative documentation. We believe our recommendations would provide the Corporation a level of assurance that adequate examination procedures have been performed in support of CAMELS ratings of 4 or 5. The documentation we are recommending would meet the current requirements of the *DOS Manual of Examination Policies* (Manual) and provide a level of documentation we did not find in the sample of examination work papers we reviewed.

For the most part, DOS's stated corrective actions consist of issuing a memorandum by June 30, 2001, addressing the areas identified in the six recommendations. The OIG will review the draft version of the memorandum DOS said it would issue by June 30, 2001, to determine whether all six recommendations have been adequately addressed. In reviewing the memorandum, we will consider the results of the DOS Process Redesign effort.

Recommendation 1 – Require and ensure that examiners use the expanded and impact analysis sections of the ED modules to document work performed in areas with significant deficiencies or weaknesses and

Recommendation 2 – Clarify existing guidance on how expanded analysis procedures and impact analysis procedures should be documented in examination workpapers.

DOS stated it would issue a memorandum by June 30, 2001 that will replace guidance outlined in the December 1998 and March 1999 Regional Director Memoranda. As discussed elsewhere in this report, senior DOS management told us that these guidelines did not require examiners to document their expanded review and analysis via the ED modules. DOS also stated that follow-up presentations regarding documentation requirements would be made at management and training conferences as necessary. However, DOS proposes to use alternative forms of documentation to record the impact analysis work performed. In regard to Recommendation 2, DOS also agreed to provide clarifying guidance on documenting the expanded and impact analysis procedures in

examination workpapers. DOS said that this guidance would conform to its response for Recommendation 1, taking into account any impact from DOS's current Process Redesign initiative.

In DOS's response concerning the impact analysis section of Recommendation 1, DOS stated that documentation did not always have to be included in the impact analysis area of the ED modules. Alternatively, DOS offered examples of other types of work products that it believes constitutes adequate documentation of the impact analyses performed. While these documents appear sufficient, in cases where impact analyses are not documented in these alternative types of work products, DOS should instruct examiners to prepare appropriate documentation. Furthermore, DOS should include such guidance in its proposed memorandum to be issued by June 30, 2001. The OIG will review DOS's memorandum after its issuance to determine whether Recommendations 1 and 2 have been adequately addressed.

Recommendation 3 – Require examiners to identify and discuss within the Scope Memorandum the need to perform expanded procedures when the results of the pre-examination reviews indicate the potential areas of significant deficiencies or weaknesses are present.

DOS agreed with this recommendation and said it would issue a memorandum by June 30, 2001, to reinforce the guidance already in place. As we stated in our draft report, the Risk Scoping Activities module contains guidance requiring that Scope Memoranda include a discussion of the ED modules to be completed and the depth of coverage in different areas. We agree that the guidance contained in the Risk Scoping Activities module is adequate and should be reinforced. The OIG will review DOS's memorandum after its issuance to determine whether this recommendation has been adequately addressed.

Recommendation 4 – Require and ensure that examiners identify and discuss within the Scope Memoranda each Primary and Supplemental ED module for each examination.

DOS agreed in principle with this recommendation but only to the extent of requiring an identification and discussion of all Primary and Supplemental modules deemed likely to be used at the time of pre-examination planning. However, DOS also takes the position that if a Primary module is not specifically discussed in the Scope Memorandum, it is understood that normal examination analysis will be performed. As we stated elsewhere in this report, the Risk Scoping Activities module contains guidance requiring that the Scope Memorandum include, among other things, a summary of examination procedures, to include a discussion of the ED modules to be completed and the depth of coverage in different areas. DOS agreed to reinforce the existing guidance contained in the Risk Scoping Activities module in a memorandum that DOS will issue by June 30, 2001. We are also aware of potential changes to the Scope Memorandum guidance as a result of the DOS Process Redesign initiative. The OIG will review DOS's memorandum after its issuance to determine whether this recommendation has been adequately addressed.

Recommendation 5 – Emphasize the role of Case Managers and FOS/SEs in ensuring the implementation of the pre-examination planning process which includes the initial identification and determination of the appropriate level of review to be conducted within the ED modules. In part, national guidance should be provided that communicates DOS’s expectations as to the goals, roles, and responsibilities of Case Managers and FOS/SEs within the pre-examination planning process.

DOS agreed to emphasize the role of the Case Manager, Field Office Supervisor, and Supervisory Examiner in ensuring the implementation of the pre-examination planning process. DOS stated that it would issue a memorandum to each regional office by June 30, 2001 that will restate the need for each regional office to ensure that the goals, roles, and responsibilities of the above personnel are established for the pre-examination planning process. DOS will also ensure that those guidelines follow the guidance provided in the Risk Focused Examination Program. DOS’s planned action addresses the intent of this recommendation.

Recommendation 6 – Develop a national requirement for post-examination analysis, including guidance for preparing and completing post-examination memoranda similar to the instructions issued by the Chicago Regional Office in October 1998.

DOS agreed with this recommendation and stated that it will issue a memorandum by June 30, 2001 establishing a national requirement for post-examination analysis.

EARNINGS—EXAMINATION DOCUMENTATION MODULE

Earnings

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
MANAGEMENT AND CONTROL	
Management develops a profit plan consistent with the bank's strategic objectives.	Profit objectives may be incompatible with business activities.
Management prepares a realistic budget.	Earnings trends or gradual deterioration of profitability may be misinterpreted or unnoticed.
Management compares actual performance to projections on a periodic basis.	Operating objectives may not be achieved.
	Management may fail to evaluate the impact of growth and operating strategies.
Budget assumptions are reasonable.	Management's ability to recognize and correct deficiencies can be impeded by unrealistic expectations.
	Usefulness of the budget for comparative purposes can be nullified by unrealistic assumptions.
	Unreasonable assumptions may compromise long-term earnings potential by overemphasizing short-term performance.
Management has established adequate internal controls over bank revenues and expenses.	Weak controls may increase the bank's exposure to errors and omissions and impair accurate accounting of bank activities.
	Inadequate controls increase the potential for fraud and abuse.
Independent reviews and audits discuss deficiencies in bank accounting.	Identification, communication, and correction of deficiencies may be inadequate.
Information systems and management reports provide accurate information concerning earnings performance.	The board of directors may be inadequately informed and unable to properly evaluate earnings performance.
	Consolidated Reports of Income and Condition and published statements could be inaccurate.
Management's risk orientation does not expose earnings to adverse fluctuations.	Management may sacrifice prudent underwriting standards or investment criteria for higher-yielding, higher-risk asset activities to improve earnings.
Management controls growth.	Overly aggressive efforts to stimulate growth may have detrimental long-term effects on earnings (loan losses, increased interest expense, etc.).

APPENDIX 1

EARNINGS—EXAMINATION DOCUMENTATION MODULE

Standards	Associated Risks
PERFORMANCE	
<p>The level of earnings is sufficient to support operations and maintain capitalization.</p> <p>The level of earnings is appropriate for the bank's risk profile.</p>	<p>Capital protection may be adversely affected if earnings are insufficient to absorb losses.</p> <p>Lack of profitability may compromise the ability of the bank to withstand asset quality problems, interest rate movements, or variances in non-interest income and expenses.</p> <p>Earnings may be insufficient to augment capital and thus support asset growth.</p>
<p>The quality of earnings is satisfactory.</p>	<p>Earnings can decline in the future as risks arising from short-term strategies become evident or nonrecurring sources of income diminish.</p> <p>The level of earnings can not be sustained.</p> <p>Decline of income from operational sources can be overshadowed or obscured by nonrecurring sources of income.</p> <p>Pursuit of nonrecurring income can result in increased credit risk or market risk via imprudent securities activities, asset sales, fee-based lending, or other means.</p>
<p>Interest income is commensurate with the composition and risk profile of the bank's earning assets.</p>	<p>Unusually high or low yields relative to earning asset composition may indicate excessive risk-taking practices or an inability to properly price products. (Either situation elevates the risk to earnings and capital.)</p>
<p>Interest expense is properly controlled.</p>	<p>Inability to control funding costs can depress the net interest margin.</p> <p>Funding decisions and pricing strategies may not be economically prudent.</p>
<p>The net interest margin is sufficient to cover normal overhead expense.</p>	<p>The bank may be structurally unprofitable.</p> <p>Poor pricing strategies may result in the bank not being compensated for risks taken.</p> <p>Management may not be collecting interest owed on problem loans.</p>
<p>Overhead expenses are adequately controlled.</p>	<p>Profitability can be impaired by excessive overhead expenses.</p> <p>Burdensome overhead expenses may encourage management to engage in riskier activities to generate earnings.</p>
<p>Earnings are not materially impacted by excessive or improperly managed credit risk.</p>	<p>High levels of non-earning assets can depress the net interest margin.</p> <p>Significant loan portfolio deterioration can result in material provisions for losses.</p>

APPENDIX 1

EARNINGS—EXAMINATION DOCUMENTATION MODULE

Standards	Associated Risks
	Overhead expenses may increase due to costs associated with disposition of non-earning assets.
Earnings are not unduly vulnerable to interest rate fluctuations.	The net interest margin or other interest rate sensitive sources of income may be adversely impacted by interest rate movements.
Earnings are stable.	Erratic profitability or long-term decline of earnings can impair ability to augment capital. Material fluctuation of earnings can erode public confidence.

Earnings

Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

Do Core Analysis and Decision Factors indicate that risks are adequately managed?

Core Answer: General Comment:(If any)

Core Analysis Decision Factors

C.1. Are profit planning and budgeting practices adequate?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review functions adequate?

C.4. Are information and communication systems adequate and accurate?

C.5. Are earnings at a level appropriate for the bank's risk profile?

C.6. Are earnings sustainable?

C.7. Do the board and senior management effectively supervise this area?

Earnings

Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

Do Expanded Analysis and Decision Factors indicate that risks are adequately managed?

Expanded Answer: General Comment:(If any)

Expanded Analysis Decision Factors

E.1. Are management and control of earnings functions satisfactory?

E.2. Are earnings deficiencies or fluctuations immaterial?

EARNINGS—EXAMINATION DOCUMENTATION MODULE**Earnings**

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

PRELIMINARY REVIEW

- 1 Review previous Reports of Examination, prior examination work papers, and file correspondence for an overview of any previously identified earnings concerns.
- 2 Review the most recent audits and independent reviews and identify deficiencies concerning reliability of information systems that may affect quality and reliability of reported earnings.
- 3 Review management's remedial actions to correct examination and audit deficiencies.
- 4 Discuss with management any recent or planned changes in strategic objectives and their implications for profit plans.
- 5 Review board and committee minutes and routine management reports to determine the level and quality of management information system.
- 6 Review recent Uniform Bank Performance Reports to develop an initial assessment of overall earnings performance. Consider the impact of Chapter S tax filing status when selecting performance ratios to review.

PROFIT PLANNING AND BUDGETING

- 7 Review profit plans and budgets for years analyzed to determine if underlying assumptions are realistic. Profit plans and budgets should address the following areas with sufficient detail to match the size and complexity of the bank.
 - 7A Anticipated level and volatility of interest rates.
 - 7B Local economic conditions.
 - 7C Funding strategies.
 - 7D Asset and liability mix and pricing.
 - 7E Growth objectives.
 - 7F Interest rate and maturity mismatches.
- 8 Determine if management compares budgeted performance to actual performance on a periodic basis and modifies projections when interim circumstances change significantly.
- 9 Review earnings performance relative to budget forecasts.

INTERNAL CONTROLS

- 10 Review management's procedures to prevent, detect, and correct errors and inaccuracies.

EARNINGS—EXAMINATION DOCUMENTATION MODULE

11 Determine if income and expense posting, reconciliation, and review functions are independent of each other. Consider testing selected income and expense activity to observe the operational flow of transactions. Areas commonly selected for review are:

11A Large volumes of other income (miscellaneous, service fees, or any other unusual accounts).

11B Proper treatment of loan origination fees per SFAS 91.

11C Insider expense accounts.

11D Management fees or other payments to affiliates.

11E Significant legal fees.

12 Determine if significant income, expenses, and capital charges are reviewed and authorized.

13 Determine if insider related items are routinely reviewed for authorization and appropriateness.

AUDIT AND INDEPENDENT REVIEW

14 Determine that the audit or independent review program provides sufficient review relative to the bank's size, complexity, and risk profile. These activities should:

14A Recommend corrective action when warranted.

14B Verify implementation of corrective action.

14C Assess separation of duties and internal controls.

14D Determine compliance with profit planning objectives, accounting standards, and Call Report Instructions.

14E Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.

14F Include sufficient transaction testing to provide assurances income and expenses are accurately recorded in appropriate periods.

INFORMATION AND COMMUNICATION

15 Determine if managerial reports provide sufficient information relative to the size and risk profile of the institution.

16 Evaluate the accuracy and timeliness of reports produced for the board and executive management. These may include:

16A Periodic earnings results.

16B Budget variance analyses.

16C Income projections.

16D Large item reviews.

EARNINGS—EXAMINATION DOCUMENTATION MODULE

16E Insider related transaction disclosures.

16F Tax planning analyses.

17 Validate the accuracy of Reports of Income where necessary. Use bank work papers, the general ledger, downloaded exception reports, and interviews with bank personnel to verify the accuracy of Consolidated Reports of Income and Condition schedules RI, RI-A, RI-B, RI-C, and RC-K.

RATIO AND TREND ANALYSIS

18 Assess the level, trend, and sustainability of return on average assets relative to historical performance, peer comparisons, the organization's risk profile, and local economic conditions. Possible indicators of existing or impending problems include:

18A Material fluctuations in the return on average assets.

18B Inordinately high or low return on assets.

18C Poor profitability.

18D Significant variation of adjusted return on average assets from return on average assets.

18E Poor core earnings.

18F Increasing volatility or unfavorable trends.

18G Significant deviations from budget projections.

19 Evaluate the level and stability of the bank's net interest margin.

20 Evaluate the level and trend of overhead expenses.

21 Evaluate the level, trend, and sources of non-interest income.

22 Review the level and trend of provisions for loan and lease losses (PLLL) to determine the impact of asset quality on earnings. Consider the Adjusted Net Operating Income to Average Assets relationship.

23 Review the level and trend of non-operating gains and losses and their impact on earnings.

24 Evaluate the level and trend of income tax payments recognizing the institution's basis for filing taxes.

BOARD AND EXECUTIVE MANAGEMENT SUPERVISION

25 Determine if board records document routine attention to bank earnings and timely responses to significant budget deviations.

26 Assess compliance with bank policies, applicable regulations, and governing accounting standards.

EARNINGS—EXAMINATION DOCUMENTATION MODULE**Earnings**

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

PROFIT PLANNING AND BUDGETING

- 1 Assess the significance and determine causes of budgeting deficiencies. Examiners should address areas that do not appear realistic in the comment section of the Risk Management pages. (FDIC)
- 2 Consider requesting revised budget projections using modified assumptions.

INTERNAL CONTROLS

- 3 Determine the causes and potential impact of inadequate accounting or reporting practices on earnings.
- 4 Verify source documents to general ledger entries to determine if errors on Consolidated Reports of Income and Condition are influencing performance ratio levels and trends.
- 5 Where internal controls are deemed insufficient, consider transaction testing to verify the authorization, propriety, and accuracy of reviewed activity.

AUDIT AND INDEPENDENT REVIEW

- 6 Research deficiencies cited in audit or independent review findings to determine the underlying causes and assess management's corrective efforts.
- 7 Consider expanding examination activities in areas of concern.

INFORMATION AND COMMUNICATION

- 8 Assess the significance of internal management reporting deficiencies and determine underlying causes.
- 9 Determine needed changes in report distribution.
- 10 Consider detailed review of Consolidated Reports of Income and Condition information where significant errors are indicated.
 - 10A Request revised filing where identified errors are material and revise Report of Examination data where necessary.
 - 10B Assess the competency of the Consolidated Reports of Income and Condition preparer.

RATIO AND TREND ANALYSIS

- 11 Determine the underlying reasons for a low or erratic return on average assets and discuss management's plans to improve performance.

- 12 Ascertain if low or inconsistent Net Interest Margin is the result of asset levels, yields, and composition or the level, composition, and costs of funding.
- 13 Where earnings concerns derive from interest income levels, determine the underlying cause. Potential reasons for depressed interest income levels may be:
- 13A The level and trend of nonaccrual loans and other nonearning assets.
 - 13B Ineffective asset pricing strategies.
 - 13C Investment decisions.
 - 13D Asset distribution.
 - 13E Increasing competition.
- 14 If interest income levels are fluctuating severely, review IRRSA (FDIC) or other interest rate reports for possible interest rate risk exposure.
- 15 Review the common-sized balance sheet information (asset composition as a percent of total assets) in the UBPR for unusual shifts in balance sheet structure or unusual volumes of certain types of assets (excessive cash and due from) that may be influencing interest income.
- 16 Where earnings concerns derive from interest expense levels, determine the underlying cause for concern. Potential reasons for elevated interest expense may be:
- 16A Increasing use of higher-cost borrowings.
 - 16B Increasing concentration of high-cost deposits.
 - 16C Unfavorable migration of core deposits to higher yielding products.
 - 16D Ineffective pricing practices.
 - 16E Increasing competition.
- 17 Determine those areas of overhead expenses significantly impairing the institution's earnings.
- 17A If salary expense appears excessive, review salary listings to determine the underlying source(s) of elevated expenses.
 - 17B Review personnel benefits to determine if benefits are contributing to increased personnel expenses.
 - 17C Determine if the bank properly reports employee benefits and does not pay for improper benefits.
 - 17D Determine if the bank receives proper authorization for employee benefits from the board of directors.
 - 17E Assess the reasonableness of incentive compensations.
 - 17F Analyze efficiency of staffing levels relative to the organization's business lines and risk profile.

- 17G Determine if personnel cuts (downsizing) and occupancy expense reductions are negatively impacting the bank's ability to prudently supervise banking activities.
- 18 Determine appropriateness of fixed asset investments and lease payments.
- 19 Review service fees paid to affiliated parties and others for adequate documentation and appropriateness.
- 20 Review legal expenses for underlying causes of increased legal charges. The following situations are some possible reasons for elevated legal expenses:
- 20A Administration and disposal of problem assets.
 - 20B Involvement in significant litigation.
 - 20C Significant changes in the bank's strategic objectives (purchases, mergers, etc.).
- 21 Review the source or activity that is generating significant volumes of non-interest income and determine if the current volume is sustainable.
- 22 Determine management's rationale or motivation for increased reliance on non-interest income. Consider the strategic decisions that underlie the increased level of non-interest income. (If the bank is entering into a new type of service or business, determine if management prudently researched the risks and rewards of the new venture.)
- 23 When asset quality poses concerns, analyze the potential impact on operating profitability caused by:
- 23A Increasing levels of nonperforming assets.
 - 23B Escalating administrative, legal, and collection expenses.
 - 23C Additional Provisions for Loan Losses.
- 24 Identify which assets were sold and investigate management's rationale for selling the asset (excluding ORE), including the following possibilities:
- 24A Restructuring of loan or securities portfolio.
 - 24B Attempting to bolster earnings by selling high-yielding assets.
 - 24C Experiencing liquidity pressures.
- 25 Determine if the level of gains on sale of assets is a reliable source of recurring income.
- 26 Research large tax expenses to determine appropriateness. (Poor tax planning, timing of holding company tax payments.)
- 27 Review erratic tax levels to determine underlying reason for fluctuations. Significantly fluctuating tax liabilities may be indicative of:
- 27A Inaccurate financial reporting.
 - 27B Inaccurate accounting for applicable taxes.
 - 27C Poor tax planning.

EARNINGS—EXAMINATION DOCUMENTATION MODULE

Expanded Analysis

27D A change in tax basis.

28 Consider independent verification of tax calculations, amount, and timing of required interim payments.

BOARD AND EXECUTIVE MANAGEMENT SUPERVISION

29 Determine why any previously identified deficiencies remain uncorrected.

30 Determine the reasons for poor compliance with policy guidelines, governing accounting standards, or applicable regulations.

31 Identify needed corrective actions and assess the adequacy and viability of management's commitments.

Earnings

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

- 1 Analyze the impact of earnings deficiencies on the bank's overall condition. Estimate the future earnings levels and calculate their impact on capital and liquidity if these continue.
- 2 Determine the need for administrative or enforcement actions, formulate specific recommendations, and advise the appropriate supervisory officials on the nature of the concerns.
- 3 Discuss the possibility of administrative or enforcement actions with executive management and the board of directors.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
Office of the Director

Division of Supervision

DATE: March 13, 2001

MEMORANDUM TO: David H. Loewenstein
Assistant Inspector General

FROM: Michael J. Zamorski *Michael J. Zamorski*
Acting Director

SUBJECT: Draft Report Entitled *Audit of DOS's Use of Expanded and Impact Examination Procedures in the Risk-Focused Examination Process*

The Division of Supervision (DOS) appreciates the opportunity to respond to this Draft Report prepared by the FDIC's Office of Inspector General (OIG). As the results of the audit show, DOS has taken several steps to more fully implement the risk-focused examination process, especially in the area of core analysis. Opportunities exist to further improve the effectiveness of the risk-focused examination program in the areas of expanded analysis, examination planning, and post-examination analysis. We agree with the thrust of the recommendations included in the Draft Report and will take appropriate action to implement those recommendations. However, we note that if all the recommendations were implemented in their entirety, in some cases considerable examiner time might be devoted to the preparation of additional, and often duplicative, workpaper documentation. This is an issue we would greatly appreciate having the opportunity to discuss with you in relation to our ongoing Process Redesign project. That project is approaching completion (March 31, 2001 completion deadline). This initiative involves a thorough assessment of the Division's supervisory processes with a goal of identifying ways to improve and streamline them. A project group is reviewing all phases of safety and soundness examination procedures including the use of the ED modules. Therefore, the recommendations and possible actions from this initiative may affect our policies and requirements in this area. With that in mind, we have offered a few alternatives to some parts of the recommendations.

OIG's Recommendation (1): Require and ensure that examiners use the expanded and impact analysis sections of the ED modules to document work performed in areas with significant deficiencies or weaknesses.

DOS's Response:

Existing guidance in the DOS *Manual of Examination Policies* ("Manual") already requires examiners to use the expanded and impact analysis sections of the ED modules when significant deficiencies or weaknesses exist. Similarly, current guidance in the *Manual* requires examiners to document work performed in the expanded analysis area. A copy of the applicable section of the *Manual* is included as an attachment (see page 8). We will issue a memorandum by June 30, 2001 to reemphasize these instructions to assure that the work is documented.

Such documentation need not always be included in the Impact Analysis area of the ED modules. The *DOS Manual of Examination Policies* and the *Formal and Informal Action Procedures Manual* already require adequate documentation of the work performed in these areas within other types of work products. As a result, documenting the Impact Analysis section of the modules would duplicate documentation that is already required in a different format. We would appreciate clarification as to the adequacy of the documentation requirements contained in these manuals. A few examples of specific items from the Impact Analysis section of the ED modules will illustrate those requirements.

Example: Every ED module contains an Impact Analysis procedure similar to the following: “*Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns.*” This procedure is derived from the Formal Administrative Actions section of the *Manual*. The *Manual* states that DOS policy “presumes either a formal or informal administrative action will be taken on banks with Composite Uniform Bank Ratings of “3,” “4,” or “5” unless specific circumstances argue strongly to the contrary.” A separate memorandum to the Regional Director is required that details each specific undesirable and objectionable practice, the facts related to each practice, suggested measures to correct the practice, and specific comments relative to the existing management situation. This required documentation has long been a policy of DOS and is believed adequate. A copy of this part of the *Manual* is included as an attachment (see pages 9-13).

Example: Almost every individual ED module contains an Impact Analysis procedure similar to the following: “*Investigate the circumstances and facts surrounding apparent violations and prepare recommendations for Civil Money Penalties, if appropriate. (The Manual details specific instances in which CMPs may be assessed.)*” This procedure is derived from the Civil Money Penalties section of the *Manual*. The *Manual* requires that when fineable violations, unsafe or unsound banking practices, or breaches of fiduciary duty are discovered, examiners should complete the Civil Money Penalty Matrix. Completion of the Matrix should be adequate documentation. A copy of this part of the *Manual* is included as an attachment (see pages 14-15).

Example: Almost every individual ED module contains an Impact Analysis procedure similar to the following: “*Discuss potential regulatory responses with management and the board.*” The *Manual*, in the Report of Examination Instructions section, requires a summary of the meeting with management or the board of directors on the Examination Conclusions and Comments page. This would include a summary of any discussions of potential regulatory responses. We believe this provides adequate documentation. A copy of this part of the *Manual* is included as an attachment (see page 16).

OIG’s Recommendation (2): Clarify existing guidance on how expanded analysis procedures and impact analysis procedures should be documented in examination workpapers.

DOS's Response:

Clarifying guidance on documenting the expanded and impact analysis procedures in the examination workpapers will be provided. The guidance will conform to our response to Recommendation (1) and will also take into account any impact from the current process redesign initiative. The new memorandum will be issued by June 30, 2001 and will replace guidance outlined in the December 1998 and March 1999 R/D Memoranda. Follow-up presentations will also be done at management and training conferences as necessary.

OIG's Recommendation (3): Require examiners to identify and discuss within the Scope Memorandum the need to perform expanded procedures when the results of the pre-examination reviews indicate that potential areas of significant deficiencies or weaknesses are present.

DOS's Response:

During the planning process examiners should make a good faith effort to determine if some expanded analysis procedures are likely to be performed based on available information. Examiners should also be encouraged and permitted to identify and discuss within the Scope Memorandum the expectation of performing expanded procedures. Indeed, as the OIG notes in the Draft Report, the Risk Scoping Activities module currently provides such guidance.

In order to be responsive to the OIG's comments, DOS proposes to reinforce the requirement that the expanded procedures be discussed whenever it appears likely that the procedures will be necessary. The pre-examination review and risk-scoping process is designed primarily to identify areas that are well controlled or that pose minimal risk to the institution and can be reviewed on a limited basis. If such conditions are not identified, then examiners are expected to work through the analysis of the functional area in a normal fashion and decide whether expanded procedures are warranted based on their conclusions from the Core Analysis Decision Factors.

Examiners should be expected to work through the core analysis procedures before making a determination of whether "significant deficiencies or weaknesses are present" and whether there is a need to perform expanded procedures. It is inconsistent to expect the examiner to make these determinations during the pre-examination review and it also would be inappropriate to draw such conclusions before beginning the onsite portion of the examination.

We do not believe there is a weakness in the program if the Scope Memorandum does not specifically discuss the need to perform expanded procedures even when such procedures are eventually performed during the examination. In situations where expanded analysis is eventually performed, the Scope Memorandum should only be expected to indicate that a full core analysis was to be completed.

In 2000 the Division reviewed several Scope Memoranda from every region. The results showed that most were completed according to the guidance provided in the Risk Scoping Activities module. This seems to indicate that the current guidance in the Risk Scoping Activities module is adequate and that examiners have made a good faith effort to determine if expanded procedures are likely to be performed during the planning process. However, this guidance will be reinforced in the memorandum to be issued by June 30, 2001.

OIG's Recommendation (4): Require and ensure that examiners identify and discuss within the Scope Memoranda each Primary and Supplemental ED module for each examination.

DOS's Response:

The implementation of such a requirement would commit considerable additional examiner time into the preparation of the Scope Memorandum; the supervisory benefit to be derived from this would be minimal in many cases. OIG states in its Draft Report, "we believe that in instances when a module is not identified or discussed, the Field Office Supervisor, Case Manager, or Assistant Regional Director may not know what level of review will be conducted and whether the module's absence is intentional or an oversight. As a result, we are concerned that if the examiner does not address particular elements within the Scope Memorandum, a comprehensive review of the institution may not be performed and its potential impact to the bank may not be considered in the institution's assessment."

Our review of Scope Memoranda in 2000 indicated that if a Scope Memorandum is completed according to the current guidance in the Risk Scoping Activities module, the Field Office Supervisor, Case Manager, and Assistant Regional Director can determine whether a comprehensive review of the institution is being performed regardless of whether each module is listed and discussed. The current guidance for the Scope Memorandum, included in the Risk Scoping Activities module, is comprehensive and includes the following information:

- Summary of pre-examination meeting.
- Summary of audit and internal control environment.
- Preliminary risk assessment addressing CAMELS components.
- Summary of examination procedures. Includes a discussion of the modules to be completed and the depth of coverage in different areas.
- Summary of anticipated loan review.
- Examination staffing.

Taken as a whole, the discussion of these six areas in the Scope Memorandum should adequately address the OIG's concerns. However, DOS will reinforce the guidance in a memorandum to be issued by June 30. We will stress completion of all primary modules and supplemental modules whose use has been judged likely at the time of prescoping.

As the OIG has noted, there is a distinction between Primary and Supplemental modules. Current instructions require completion of all Primary modules unless the Scope Memorandum specifically discusses the area and directs that a limited review be performed. Therefore, if a Primary module is not specifically discussed, it is understood that normal examination analysis will be performed. Conversely, the Supplemental modules are primarily a resource for examiners. Examiners may choose to use the module when that activity is a significant area of a bank's operation. If a Supplemental module is not specifically discussed, it is implied that the module will not be used. If a specific Supplemental module is planned to be used in the bank being examined, the current practice is to discuss that module in the Scope Memorandum. We are not certain that requiring examiners to list and discuss every Primary and Supplemental module (there are currently 18 such modules and three more are under development) is necessary if the examiner can indicate the same information in a few sentences.

Current guidance allows examiners to tailor this part of the Scope Memorandum based on the size and complexity of the bank being examined. For the larger, more complex institutions, examiners generally list each Primary and Supplemental module and discuss the depth of coverage. However, for the smaller community banks, examiners will generally indicate that the Primary modules will be followed according to normal guidelines, and then indicate if any Supplemental modules will be used. To list and discuss each of the modules in a small community bank would add considerable time to the preparation of the Scope Memorandum for the approximately 2,500 such examinations conducted each year.

OIG's Recommendation (5): Emphasize the role of Case Managers and FOS/SEs in ensuring the implementation of the pre-examination planning process which includes the initial identification and determination of the appropriate level of review to be conducted within the ED modules. In part, national guidance should be provided that communicates DOS's expectations as to the goals, roles, and responsibilities of Case Managers and FOS/SEs within the pre-examination planning process.

DOS's Response:

The roles of the FOS/SEs and Case Managers in the planning process should be specified. However, the extent of their involvement should be left up to the individual regions, as circumstances among the regions differ significantly. For example, Case Managers with a portfolio of 5 or 6 relatively large and complex institutions are expected to have a more active role in the supervision of these banks than Case Managers with a portfolio of 50 or 60 small, well-rated community banks.

The role and responsibilities of Case Managers for planning examinations for larger financial institutions and examinations that involve other regulatory agencies or multiple FDIC offices are included in *DOS's Case Manager Procedures Manual*. A copy of this guidance is included as an attachment (see pages 19-24).

The responsibilities of Case Managers and the FOS/SEs for all other examinations, including those of smaller community banks, are outlined in directives from each of the respective DOS Regional Offices. To achieve maximum efficiencies, these assigned responsibilities are based on the structure and organization of the Regional Office and the types of banks they supervise.

Our current approach achieves the substance of the OIG's recommendation. However, we will restate the need for each regional office to ensure that the goals, roles, and responsibilities of Case Managers and FOS/SEs for the pre-examination planning process are established and that they follow the guidance provided in the Risk Focused Examination Program. A memorandum to that effect will be issued by June 30, 2001.

OIG's Recommendation (6): Develop a national requirement for post-examination analysis, including guidance for preparing and completing post-examination memoranda similar to the instructions issued by the Chicago Regional Office in October 1998.

DOS's Response:

A national requirement for post-examination analysis will be developed. This analysis is a helpful management tool. While most, if not all, of the regional offices have issued written guidelines for performing post-examination analysis and for completing a Post-Examination Memorandum, a memorandum with this national requirement will be issued by June 30, 2001.

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 on 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	<p>Management agreed with the recommendation; however, its response contains alternative courses of action. DOS agreed to require and ensure that its examiners use the expanded analysis sections of the ED modules to document expanded work performed. However, DOS did not agree to require the use of ED modules to document the impact analysis performed.</p> <p>DOS will issue a memorandum to reemphasize the existing guidance in the DOS <i>Manual of Examination Policies</i> that requires examiners to use and document the expanded analysis section and to use the impact analysis section of the ED modules when significant deficiencies or weaknesses exist. DOS will also provide guidance to examiners as to what constitutes adequate documentation of the impact analysis procedures performed.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes
2	<p>Management agreed with the recommendation.</p> <p>DOS will issue a memorandum that will provide clarifying guidance on documenting the expanded and impact analysis procedures in the examination workpapers. DOS will also provide follow-up presentations, as necessary, to clarify the documentation requirements at management and training conferences.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes
3	<p>Management agreed with the recommendation.</p> <p>DOS will issue a memorandum that will reinforce the existing guidance contained within the Risk Scoping Activities module that requires Scope Memoranda to include a discussion of the ED modules to be completed and the depth of coverage in different areas.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
4	<p>Management agreed with the recommendation; however, its response contains alternative courses of action.</p> <p>DOS will issue a memorandum that will reinforce the guidance contained within the Risk Scoping Activities module. DOS will require and ensure that examiners identify and discuss within the Scope Memoranda the Primary and Supplemental ED module in each examination but only when the use of the specific ED module has been judged likely at the time of examination pre-planning. DOS will also clarify its positions that:</p> <p>(1) If a Primary module is not specifically discussed in a Scope Memorandum, it is understood that normal examination analysis will be performed and</p> <p>(2) If a Supplemental module is not specifically discussed in a Scope Memorandum, it is implied that the module will not be used.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes
5	<p>Management agreed with the recommendation; however, its response contains alternative courses of action.</p> <p>DOS will issue a memorandum to each regional office that will restate the need for each regional office to ensure the goals, roles, and responsibilities of Case Managers, Field Office Supervisors, and Supervisory Examiners for the pre-examination process are established and that they follow the guidance provided in the Risk Focused Examination Program.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes
6	<p>Management agreed with the recommendation.</p> <p>DOS will issue a memorandum that establishes a national requirement for post-examination analysis.</p>	June 30, 2001	Regional Directors Memorandum	N/A	Yes