Office of Inspector General

Audit of the Small Community Bank Examination Process

Board of Governors of the Federal Reserve System

August 2012

OFFICE OF INSPECTOR GENERAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

CONSUMER FINANCIAL PROTECTION BUREAU

August 31, 2012

MEMORANDUM

TO: Michael S. Gibson
Director, Division of Banking Supervision and Regulation

FROM: Anthony J. Castaldo
Associate Inspector General for Inspections and Evaluations

SUBJECT: OIG Report: *Audit of the Small Community Bank Examination Process*

On February 10, 2012, we received a request from the Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs to review the Board of Governors of the Federal Reserve System's (Board's) examination process for small community banks, including examination timeliness and how the Board ensures consistency in the administration of examinations throughout the Federal Reserve System. We also reviewed the ability of Board-regulated institutions to question examination results through the Federal Reserve System's Ombudsman program or other appeals processes and the frequency and results of examination appeals.

In conducting our audit, we interviewed staff from the Board's Division of Banking Supervision and Regulation (BS&R) and Division of Consumer and Community Affairs and the Federal Reserve System's Ombudsman. We reviewed the Board's *Commercial Bank Examination Manual* and relevant supervisory guidance. In addition, we obtained safety and soundness examination timeline data from the Board's National Examination Data System for our analysis.

We found that the Board's examination oversight includes System-wide supervision and communication, detailed examiner guidance, training, and quality assurance. This structure is designed to ensure consistency of state member bank examinations throughout the Federal Reserve System. We found that, on average, Reserve Banks issued examination reports within the time frame required by the Board's *Commercial Bank Examination Manual.* We also found that all 12 Reserve Banks have established appeals policies that follow Board guidance.

Our report contains one recommendation designed to improve the reliability of the data in the National Examination Data System database. We recommend that the Director of BS&R improve controls for verifying the accuracy of the data entered into the National Examination Data System.

We provided you with a copy of our report for review and comment. In your response, you stated that BS&R staff agreed with the summary conclusions in the report and that BS&R had initiated a System effort to strengthen the examination database management reviews. In our opinion, the actions you described are appropriate for the recommendation, and we plan to follow up on the division's actions to ensure that the recommendation is fully addressed. Your comments are included as an appendix to our report.

We appreciate the cooperation that we received from Board staff during our audit. The principal contributors to this report are listed in appendix 3. This report will be added to our public website and will be summarized in our next semiannual report to Congress. Please contact Timothy Rogers, Senior OIG Manager, at 202-973-5042 or me at 202-973-5024 if you would like to discuss this report or any related issues.

Enclosure

cc: Chairman Ben S. Bernanke
Vice Chair Janet L. Yellen
Governor Elizabeth A. Duke
Governor Daniel K. Tarullo
Governor Sarah Bloom Raskin
Governor Jeremy C. Stein
Governor Jerome H. Powell
Mr. Robert deV. Frierson
Ms. Margaret M. Shanks

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Audit of the Small Community Bank Examination Process

Board of Governors of the Federal Reserve System

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Abbreviations

Board	Board of Governors of the Federal Reserve System
BS&R	Division of Banking Supervision and Regulation
CBEM	*Commercial Bank Examination Manual*
DCCA	Division of Consumer and Community Affairs
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
NED	National Examination Data System
OIG	Office of Inspector General
Reserve Bank	Federal Reserve Bank
State Member Banks	State-chartered banks that are members of the Federal Reserve System

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I. Background

On February 10, 2012, the Inspectors General of the Board of Governors of the Federal Reserve System (Board), the Department of the Treasury, the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration received a letter from the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs requesting that the Offices of Inspector General (OIGs) report on their agency's examination process for small community banks and credit unions, including examination timelines and how each agency ensures consistency in the administration of examinations across the country. The Chairman also requested that the OIGs review the ability of regulated institutions to question examination results, such as through an Ombudsman, an appeals process, or other channels, and report on the frequency and success of such appeals.

The Board and, under delegated authority, the Federal Reserve Banks (Reserve Banks) supervise state-chartered banks that are members of the Federal Reserve System (state member banks). The Department of the Treasury's Office of the Comptroller of the Currency charters and supervises national banks. The FDIC supervises state banks that are not members of the Federal Reserve System (state nonmember banks). State banks are not required to become members of the Federal Reserve System, but they may elect to do so if they meet certain standards set by the Board. In their respective roles, the Board and the FDIC share the responsibility of supervising state-chartered banks with state banking agencies.

II. Objective, Scope, and Methodology

We conducted an audit of the Board's small community bank examination process. Our objective was to report on

- the Board's examination process for small community banks, including examination timelines and how the Board ensures consistency in the administration of examinations throughout the Federal Reserve System
- the ability of Board-regulated institutions to question examination results through the Federal Reserve System's Ombudsman program or other appeals processes
- the frequency and results of examination appeals

To accomplish these objectives, we interviewed staff from the Board's Division of Banking Supervision and Regulation (BS&R) and Division of Consumer and Community Affairs (DCCA) and the Federal Reserve System's Ombudsman. We reviewed the Board's *Commercial Bank Examination Manual* (CBEM), relevant supervisory guidance, and Federal Financial Institutions Examination Council (FFIEC) programs.[1]

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1. The FFIEC was established in 1979 to promote uniform principles, standards, and report forms for the federal examination of financial institutions. The members of the FFIEC include a Board Governor, the Comptroller of the Currency, the Chairman of the FDIC Board of Directors, the Chairman of the National Credit Union Administration Board, the Director of the Consumer Financial Protection Bureau, and the Chairman of the State Liaison Committee.

We obtained safety and soundness examination timeline data from the Board's National Examination Data System (NED) for state member banks with total assets of less than $10 billion for the five-year time period from 2007 through 2011.[2] We analyzed the data for small community banks—which we defined as banks with total assets of $1 billion or less—to determine the timeliness of the examination process. Specifically, we evaluated whether examiners complied with the Board's minimum standards for examination report completion.[3] We also selected a judgmental sample of the NED data that we received to assess their reliability. In addition, we obtained and reviewed the data for examination appeals and related information from the Ombudsman for the same period.

We conducted our fieldwork from April 2012 through July 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the review to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

III. Results of Our Audit

A. Bank Supervision Overview

The Board and, under delegated authority, the Reserve Banks supervise over 800 state member banks.[4] The supervisory process involves conducting examinations to evaluate the overall safety and soundness of state member banks. BS&R develops and implements examination policies and guidance, oversees the bank examination process conducted by the Reserve Banks, and provides examiner training in coordination with the FFIEC. Bank examinations include an assessment of the bank's risk-management practices, financial condition, and compliance with applicable banking laws and regulations.

While this report focuses on safety and soundness examinations, it is important to note that the Board is also responsible for supervising state member banks' compliance with federal consumer financial laws and regulations.[5] DCCA is responsible for the Board's consumer compliance program, promulgates related supervisory guidance, and oversees the Reserve Banks' consumer compliance examinations, which are separate from safety and soundness examinations. Consumer compliance examinations are conducted by specially trained Reserve Bank examiners.

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2. The Board defines community banks as financial institutions with total assets of under $10 billion.

3. The Federal Reserve requires its examiners to complete and file an examination report within 60 calendar days from the examination exit meeting.

4. State member banks are supervised by 1 of the 12 Reserve Banks according to their geographic location.

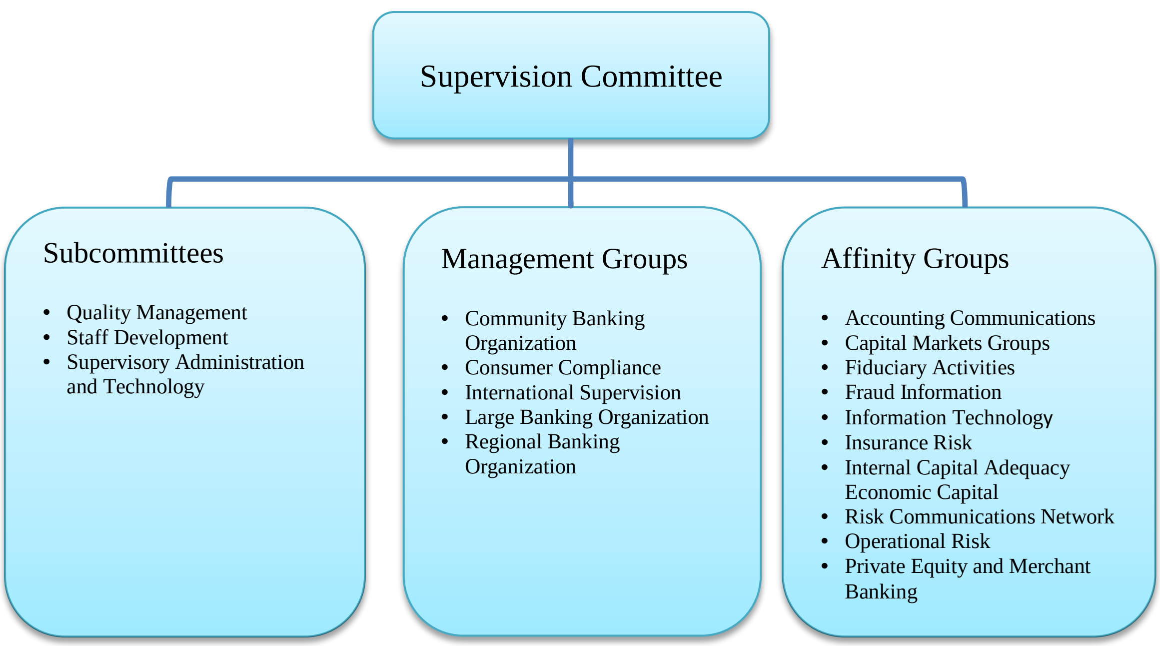
5 . The Board has supervisory authority regarding federal consumer financial law for state member banks with assets of $10 billion or less.

Oversight Structure

The Board's oversight structure includes various committees that are involved in the supervisory process. The Committee on Bank Supervision, which consists of three Board Governors, receives briefings on current issues and provides guidance on policy matters. The Supervision Committee, which is co-chaired by the Directors of BS&R and DCCA, includes the officer in charge of bank supervision at each Reserve Bank as well as the BS&R and DCCA Deputy Directors. The Supervision Committee coordinates the Federal Reserve System's supervisory efforts and sets forth the strategic plan that covers safety and soundness and consumer compliance responsibilities.

The Supervision Committee also oversees several subcommittees, management groups, and subject-matter (affinity) groups (figure 1). For example, the Quality Management Subcommittee helps ensure the integrity and effectiveness and promote quality in the Federal Reserve System's supervision function. The Community Banking Organization Management Group promotes communication among Reserve Banks, consistent implementation of supervisory policies, and effective risk-focused safety and soundness supervision of community banking organizations. Affinity groups target specific examination issue areas, such as capital markets, information technology, or operational risk.

Figure 1: Supervision Committee Structure



Examiner Guidance

BS&R develops and maintains guidance for safety and soundness examinations. The CBEM formalizes longstanding examination objectives and procedures to enhance the quality and consistency of the examination process. The manual provides comprehensive guidelines in evaluating the safety and soundness of state member banks. The CBEM is updated twice a year, and special supplements are issued as needed. In addition, BS&R communicates supervisory topics and issues (to Reserve Banks and the banking industry) through two types of formal letters:

1. Supervision and Regulation letters, which cover a wide range of banking topics, such as examination and supervision guidance, enforcement, community banking, credit risk management, financial and regulatory reporting, and liquidity risk management. Supervision and Regulation letters are provided to Reserve Banks and state member banks and are publicly available.

2. Advisory letters, which provide Reserve Bank examiners with administrative guidance, supervisory procedures, or other information. Advisory letters are only distributed within the Board and the Reserve Banks.

The FFIEC also issues to agencies and banks joint supervisory guidance that promotes uniform supervision and examination standards.

Examiner Training

The Board offers various examiner training programs for Reserve Bank examination staff. For example, the Board's Examiner Commissioning Program provides the opportunity for Reserve Bank examination staff to become commissioned examiners in one of three specialty areas: safety and soundness, consumer affairs, and information technology. The Examiner Commissioning Program coursework is divided into three levels. All examiners complete the first level, which provides examiners with core knowledge on topics such as banking business, supervisory overview, the structure and functions of the Federal Reserve System, and payments systems. Level two provides examiner candidates with special knowledge in one of the specialty areas. In the third level, Reserve Bank examination staff learn about financial institution management and obtain skills to evaluate risk management processes. Examiner candidates become eligible for commissioning after successfully completing all three levels of coursework. When space is available, the Board permits state examiners, Board and other Reserve Bank staff, and examiners from other federal agencies to attend Examiner Commissioning Program courses.

The Board provides continuing professional development courses through classroom learning and self-study courses. The Federal Reserve also offers web-based online self-study tools on topics such as compliance, examiner orientation, capital adequacy, market data, and credit skills. In addition, audio conferencing provides current supervisory and regulatory updates covering topics such as the Board's policy letters, supervisory guidance, market trends, and banking industry conditions.

The FFIEC also provides training to federal and state examiners. FFIEC training programs are designed to

- promote training efficiency by encouraging consistency of examiner education through joint sponsorship or interagency training

- develop, maintain, and deliver timely, cost-effective, state-of-the art interagency training
- serve as a clearinghouse of training opportunities offered by its member agencies

The FFIEC also provides examiners and financial institutions with a training tool for risk-management planning that covers financial privacy, information technology, and check processing.

Quality Assurance

The Board's *Guidelines for Reserve Bank Quality Management Frameworks* is designed to promote consistency among supervisory products and processes across all 12 Reserve Banks. Each Reserve Bank is responsible for establishing its own quality management framework and is encouraged to adjust quality management programs to fit its needs. The guidelines require that the framework include four distinct components: quality planning, quality implementation and control, quality assurance, and quality improvement. In addition, BS&R's Performance Management and Assessment section monitors and evaluates Reserve Banks' supervisory activities. The Performance Management and Assessment section reviews each Reserve Bank supervision function at least once every three to four years.

B. Community Bank Examination Process

Reserve Bank examiners conduct examinations of state member banks to

- provide an objective evaluation of a bank's soundness
- determine a bank's risk profile
- test a bank's compliance with banking laws and regulations
- facilitate evaluation of a bank's corporate governance and the skill levels of its board of directors and management
- identify a bank's deficiencies and weaknesses that need improvement

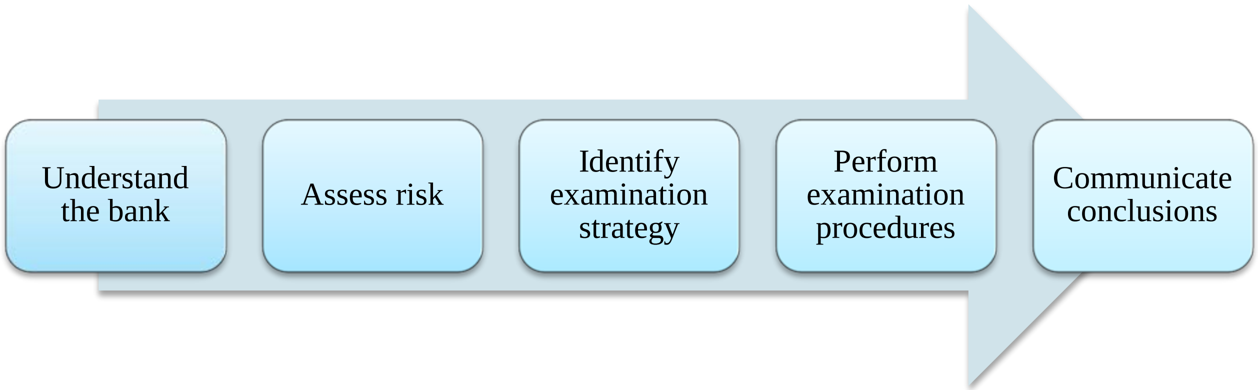
The Federal Reserve System typically examines state member banks once during each 12-month period. When a bank meets certain criteria, its examination cycle may be extended to once every 18 months.[6] The Federal Reserve System also coordinates its examinations with the bank's state supervisor and may choose to alternate examination responsibility with the state, provided that the bank's condition remains sound. If the bank's condition deteriorates, however, the bank will be examined at least every 6 months.

Risk-focused Approach

As depicted in figure 2, the Federal Reserve System follows a risk-focused approach to community bank examinations.

6. The examination cycle may be extended to once every 18 months when a bank (1) has total assets of less than $500 million, (2) is well capitalized, (3) has a management rating of 1 or 2, (4) has a composite rating of 1 or 2, (5) is not subject to a formal enforcement action, and (6) has not had a change in control within the preceding 12 months.

Figure 2: Risk-focused Examination Process



Understand the Bank

The first step in the risk-focused examination approach requires examiners to obtain an understanding of the bank and tailor examination procedures to address the highest risks. Examination guidance calls for examiners to conduct pre-examination visits to assess changes in the bank's operations and markets. In addition, examiners are encouraged to obtain the state supervisor's perspective on the bank's overall condition.

Assess Risk

The risk-focused examination approach requires examiners to consider risks, such as credit, market, liquidity, operational, legal, and reputational, when assessing the adequacy of a bank's risk-management processes and internal control. Examiners assess the bank's risk profile by reviewing correspondence and prior examinations and surveillance reports. They also evaluate the bank's internal audit, loan review, and compliance programs and may also coordinate with the bank's external auditor. The risk assessment will generally determine the examination strategy and specific testing to be conducted during the onsite examination.

Identify Examination Strategy

Reserve Bank examiners prepare a scope memorandum that internally communicates to examination staff the detailed bank examination strategy. The scope memorandum includes the following elements:

- Preliminary risk assessment
- Summary of pre-examination meeting
- Summary of audit and internal control environment
- Summary of examination procedures
- Summary of loan review
- Examination staffing

The scope memorandum typically contains examiners' preliminary risk assessment of the bank, the result of the pre-examination visit, and a summary of the bank's audit and internal control environment. It also describes the planned examination procedures, specifying areas of examination focus. In addition, examiners are directed to document the number, amount, or number and amount of loans to be reviewed. Finally, the scope memorandum includes the required staffing to ensure that appropriate skills and sufficient resources are allocated to any high-risk areas identified during the risk assessment.

Perform Examination Procedures

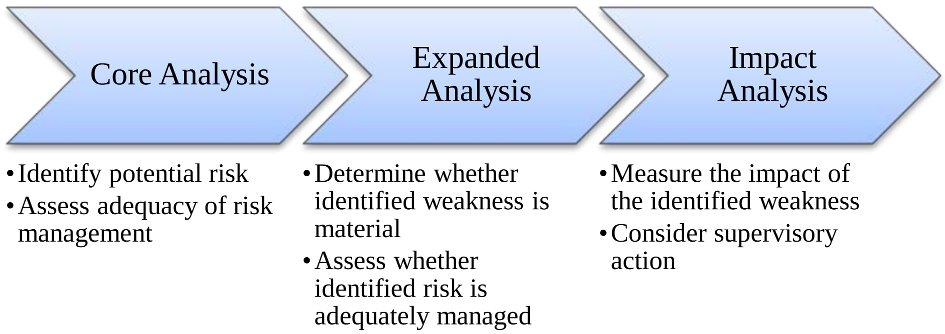
The Federal Reserve System's risk-focused examination guidance requires the use of standardized electronic community bank examination modules. These modules were developed jointly by the Federal Reserve System and the FDIC and are designed to provide consistent examination objectives for community bank examinations and to help document examination work. As shown in figure 3, examination modules are divided into three categories: primary, supplemental, and loan portfolio management. Examiners are expected to use the primary modules in assessing the bank's overall condition. The supplemental modules are used when examiners identify significant activities in a specific operation. The loan portfolio management modules provide examiners with references in evaluating the bank's loans. Examination guidance calls for examiners to tailor the use of these modules based on a bank's size, complexity, and risk profile. Furthermore, examiners are instructed to use their professional judgment in applying these modules.

Figure 3: Community Bank Examination Modules

Primary Modules	Supplemental Modules	Loan Portfolio Management Module
• Capital Adequacy • Earnings Analysis • Loan Portfolio Management • Liqudity Analysis • Management and Internal Control Evaluation • Security Analysis • Other Assets and Liabilities	• Electronic Funds Transfer Risk Assessment • International Banking • Credit Card Merchant Processing • Mortgage Banking • Electronic Banking • Related Organizations	• Construction and Land Development • Commercial and Industrial Real Estate • Residential Real Estate Lending • Commerical and Industrial Loans • Agricultural Lending • Direct Lease Financing • Floor Plan Loans • Troubled Debt Restructuring • Consumer and Check Credit • Credit Card Activities

As shown in figure 4, the examination modules employ a three-tiered process to assist examiners' review of the bank's activities. Examiners initially conduct a core analysis to identify potential risks and to assess the adequacy of the bank's risk management. Examiners perform an expanded analysis when weaknesses are identified. If weaknesses are material to the bank's condition or are inadequately managed, examiners perform an impact analysis to measure the potential effect of the material weakness on the bank's condition.

Figure 4: Three-tiered Process



Examiners evaluate six essential components of a bank's financial condition and operations using the FFIEC's Uniform Financial Institutions Rating System, also known as the CAMELS rating system. To assign a rating to each component, examiners evaluate the

- quality and adequacy of capital (C)
- quality of assets (A)
- capability of the board of directors and management (M)
- quantity, sustainability, and earnings trend (E)
- adequacy of liquidity (L)
- sensitivity to market risk (S)

Examiners rate each component based on a 1–5 numerical scale. The highest rating, 1, indicates the strongest performance and risk-management practices with the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk-management practices, and the greatest degree of supervisory concern. Examiners consider the bank's size and sophistication, the nature and complexity of its activities, and its risk profile when evaluating each component. Appendix 2 provides a more detailed explanation of the CAMELS rating system.

Examiners assign the bank a CAMELS composite rating generally based on the ratings of the six component ratings to reflect the bank's overall condition. In addition to the component ratings, examiners consider other factors, such as internal control and policy exceptions, violations of laws and regulations, quality of management, quantities of criticized loans, and other deficiencies.[7] Examiners are further expected to use judgment in assessing the bank's weaknesses and the potential adverse effects these weaknesses may have on the bank's current and future condition.

Reserve Bank examiners also assign a formal supervisory rating to the adequacy of a bank's risk management, including internal control processes. The risk-management rating reflects the effectiveness of the bank's processes to identify, measure, monitor, and control risk throughout the bank.

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7. Criticized loans include special mention loans that are exhibiting signs of weakness but have not been classified as *substandard*, *doubtful*, or *loss*.

Communicate Conclusions

Examiners vet their conclusions with Reserve Bank management and, for joint examinations, with the participating state agency. Examination results are typically communicated during an exit meeting with bank officials. Examiners may also opt to meet with the bank's board of directors to discuss examination findings. However, meetings with boards of directors are required for problem banks.[8] During such meetings, examiners discuss their findings and assessment of the bank's condition and seek the directors' commitment to improve identified deficiencies.

The CBEM requires examination findings and results to be reported to boards of directors and senior management in a clear, concise, and consistent manner. The CBEM also provides instructions for the completion of examination reports. Examiners are directed to (1) communicate the findings in writing, (2) prioritize the findings, (3) focus on significant matters that require bank management's attention, and (4) use standardized terminology for examination findings.

Examination reports are reviewed at multiple levels within the examining Reserve Bank to ensure appropriateness of examination findings. For troubled banks, BS&R staff reviews the examination results and consults with the examining Reserve Bank for appropriate supervisory actions.[9] The examination guidance states that examination reports must be filed within 60 calendar days after the exit meeting.

C. Analysis of Examination Timeliness

We analyzed the small community bank data from the Federal Reserve's NED to evaluate the time it takes Reserve Banks to complete safety and soundness examinations and issue examination reports.[10] The data included all Reserve Bank and state-led examinations of state member banks with assets of less than $1 billion from 2007 through 2011. During this period, 2,165 Reserve Bank examinations and 432 state-led examinations were conducted.[11] We found

8. Federal Reserve guidance requires that examiners meet with the board of directors when a bank is assigned (1) a CAMELS composite rating of 4 or 5; (2) a composite rating of 3, and its condition appears to be deteriorating; and (3) a composite rating of 3, and its condition has not improved since the prior examination, which also resulted in a composite 3 rating.

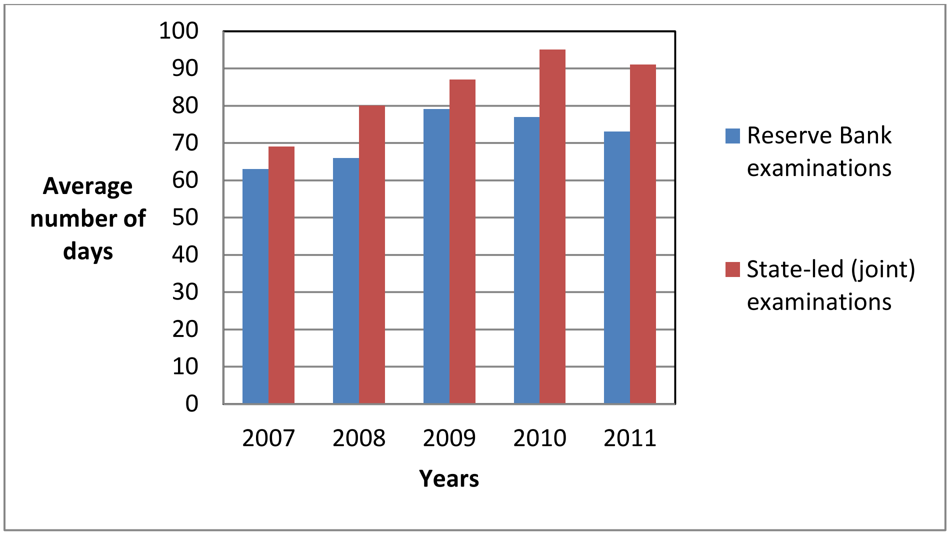
9. As defined in 12 C.F.R. § 225.71 (Subpart H of Regulation Y), a state member bank is in troubled condition if it (1) has a composite rating of 4 or 5, determined at its most recent examination; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is informed in writing by the Board or Reserve Bank that it is in troubled condition.

10. NED is specifically designed to support bank supervision. Among other things, it includes data gathered during examinations and inspections, such as financial information, ratings, and regulatory compliance actions.

11. For our analysis, we removed 4 Reserve Bank and 7 state-led joint examinations that were either ongoing as of December 2011 or did not have an exit meeting or report date in the data. We also removed 77 state independent examinations from our data because Reserve Bank examiners did not fully participate in those examinations and because the CBEM 60-day reporting requirement is not applicable to independent state examinations. Therefore, we analyzed 2,161 Reserve Bank examinations and 348 state-led joint examinations.

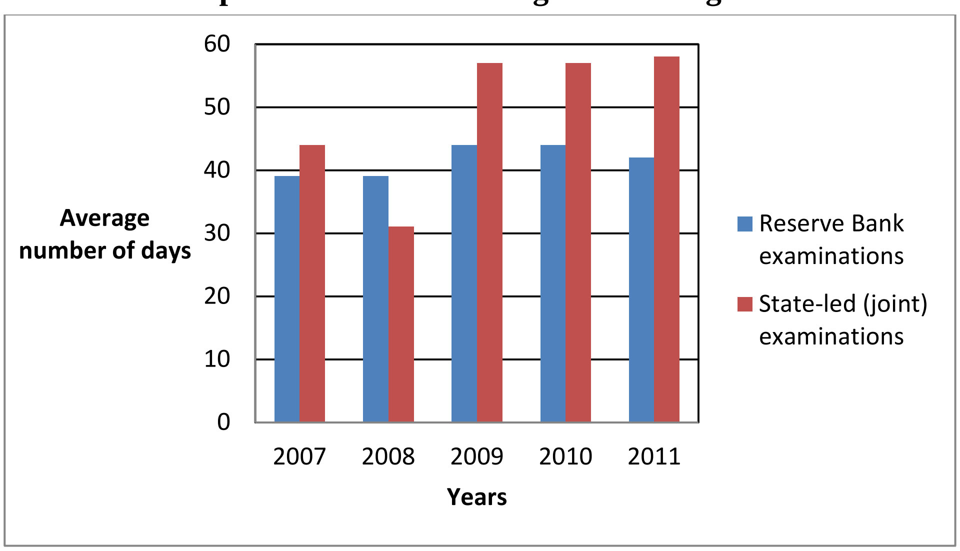
that annually, from 2007 through 2011, the average time from the beginning of the examination to issuing the report ranged from 63 days to 79 days for Reserve Bank examinations and from 69 days to 95 days for state-led joint examinations (chart 1).

Chart 1: Average Number of Days to Complete Small Community Bank Examinations and Issue Reports



Further, as illustrated in chart 2, our analysis revealed that, on average, Reserve Bank and state-led joint examination reports were issued within 60 days of the exit meeting with management. From 2007 through 2011, Reserve Bank examination reports were issued on average in less than 45 days following the examination's exit meeting.

Chart 2: Average Number of Days to Issue Small Community Bank Examination Reports after Exit Meeting with Management



We found that 93 percent of the Federal Reserve examination reports issued from 2007 through 2011 met the 60-day requirement. Seven percent (150 reports) missed this requirement by an average of approximately 26 days. Additional analysis revealed that Reserve Bank examination reports for small community banks were issued on a timely basis, regardless of CAMELS composite ratings.

Reliability of NED Data Analyzed

To evaluate the reliability of the examination data that we received, we judgmentally selected a sample of 174 Reserve Bank examinations and a sample of 107 state-led joint examinations.[12] We compared the following data elements in NED to their source examination reports:

- Federal Reserve district
- examination scope
- examination conduct type[13]
- examination start, report, and exit meeting dates
- CAMELS composite rating

As shown in tables 1 and 2, we found limited instances in which NED data were different from data cited in examination reports. For example, 7 of 174 start dates for Reserve Bank examinations in NED (4 percent) did not match the data in the examination report. However, the variance for all 7 start dates was no more than seven days. In addition, 14 of 174 Reserve Bank examination exit meeting dates in NED (8 percent) did not match the data in the examination report. Of the 14 exit meeting dates that did not match, 7 had a variance of less than five days.

12. The 107 state-led joint examinations include two examinations conducted concurrently.

13. Examination conduct type denotes whether an examination was performed independently, jointly, or concurrently.

Table 1: Analysis of Reserve Bank Examination Data in NED

	Number of instances in which:		
	NED data match examination report	**NED data do not match examination report**	**NED data not found in examination report**
District	173	1	0
Examination scope	174	0	0
Conduct type	167	5	2
Start date	160	7	7
Exit meeting date	139	14	21
Report date	167	5	2
CAMELS composite rating	171	0 [a]	3

[a] NED data for two examinations' CAMELS composite ratings were "0"; however, the examination reports did include CAMELS composite ratings. Upon further analysis, we found that these were target examinations and that the reports' CAMELS composite ratings had been carried forward from the prior examination. Accordingly, we do not categorize the NED data ratings as not matching the examination reports.

Table 2: Analysis of State-led Joint Examination Data in NED

	Number of instances in which:		
	NED data match examination report	**NED data do not match examination report**	**NED data not found in examination report**
District	107	0	0
Examination scope	105	2	0
Conduct type	106	0	1
Start date	88	18	1
Exit meeting date	69	18	20
Report date	90	16	1
CAMELS composite rating	99	4	4

Based on this analysis, we are recommending that BS&R improve controls for verifying the accuracy of data entered into NED. NED information provides important metrics that we believe should be monitored for accuracy and completeness on a routine basis. Notwithstanding these issues, in general, we believe that NED data are sufficiently reliable to support our conclusions regarding examination timeliness.

D. Examination Appeals Process

In 1995, the Board established guidelines that provide state member banks with the ability to appeal examination results.[14] This guidance was issued to comply with section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. § 4806, which requires the Board to (1) establish an independent, intra-agency appellate process that allows state member banks to seek review of "material supervisory determinations" and (2) appoint an Ombudsman.[15] The Board's guidelines state that questions about, or objections to, any material supervisory determinations made during an examination are most effectively handled informally during the examination process. However, when agreement cannot be reached, the guidelines describe the appeals process that state member banks may follow to resolve these issues.[16]

Board Procedures for Appealing a Material Supervisory Determination

The appeals process has three levels of review with time frames for appeals and decisions at each level.[17] It also establishes safeguards to protect the appealing state member bank (appellant) from retaliation. The guidance requires that the appellant's board of directors file a written appeal to the supervising Reserve Bank within 30 calendar days of receiving the examination report. As shown in figure 5, the three levels of appeals progress from an independent review panel at the Reserve Bank, to the Reserve Bank President and, finally, to a Board Governor. The guidance provides that the Board's Ombudsman, who is independent from the appeals process, will periodically contact state member banks after an appeal has been decided to ensure that no retaliation has occurred. In addition, each Reserve Bank is required to establish appropriate safeguards to protect appellants from retaliation.

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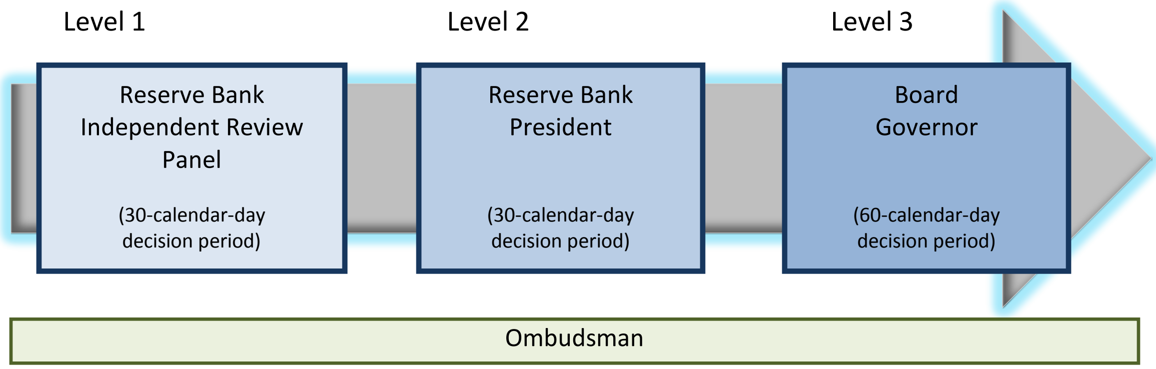
14. The guidance describing the appeals process was established in Supervision and Regulation Letter 95-18, *Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994, Intra-Agency Appeals Process*.

15. In accordance with section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994, Supervision and Regulation Letter 95-18 defines "material supervisory determination" to include all material determinations relating to examinations, such as composite ratings, the adequacy of loan loss reserves, and significant loan classifications. The definition does not include any supervisory determination that already has an independent appeals process, such as a prompt corrective action directive or a cease-and-desist order.

16. The Board made this guidance available to all institutions subject to Federal Reserve oversight, including, but not limited, to state member banks, bank holding companies and their nonbank subsidiaries, and branches of foreign banks, even though the Riegle Community Development and Regulatory Improvement Act of 1994 only required such guidance for state member banks.

17. The guidelines specify time frames, but also describe circumstances in which appeals or decisions may be adjusted. For example, an appeal may be rejected for lack of clarity or information; however, the appellant has 30 calendar days from receipt of written notice of rejection to re-file the appeal. In addition, the appellant and the review panel may jointly agree to extend the time for decision.

Figure 5: Appeal Levels



The appellant has 30 calendar days to file an appeal at each level, with the consent of the bank's board of directors. The state member bank may also contact the Ombudsman at any time about a problem resulting from regulatory activities of the Board or a Reserve Bank.

Level 1: Reserve Bank Independent Review Panel

An initial appeal is reviewed at the Reserve Bank by an independent panel comprising staff members who did not participate in the material supervisory determination, do not directly or indirectly report to the person who made the material supervisory determination under review, and are qualified to review the material supervisory determination. According to Board staff, members of the independent panel are often selected from other Reserve Banks to ensure their independence. Management of the appealing bank may appear before the review panel to present testimony and, with the consent of the review panel, other witnesses may also appear. The review panel is also required to solicit input from the Reserve Bank staff involved in the determination being appealed, relevant Board staff and, when appropriate, the staff of other supervisory agencies. The review panel's decision is due within 30 calendar days of the appeal.

Level 2: Reserve Bank President

A state member bank that is dissatisfied with the independent review panel's decision may appeal, with the consent of its board of directors, to the responsible Reserve Bank's President. The appeal must be filed with the Reserve Bank within 30 calendar days of receipt of the review panel's decision and contain all facts and arguments that the state member bank wishes to be considered. The Reserve Bank President has 30 calendar days from receipt of the appeal to render a decision.

Level 3: Board Governor

If the appealing bank is dissatisfied with the Reserve Bank President's decision, the guidance provides that the bank, with the consent of its board of directors, may appeal to the appropriate Board Governor. The appellant is required to file an appeal with the Secretary of the Board within 30 calendar days of receipt of the Reserve Bank President's decision. The guidance requires that the Governor review the appeal in consultation with the director of the appropriate division at the Board and issue a decision within 60 calendar days from the appeal's filing.

Ombudsman's Role in Examination Appeal Process

The Riegle Community Development and Regulatory Improvement Act of 1994 requires that the Ombudsman (1) act as a liaison between the Board and a state member bank (or other affected entities) with respect to any problem such party may have in dealing with the Board resulting from the regulatory activities of the agency and (2) assure that safeguards exist to encourage complainants to come forward and preserve confidentiality. The Board's Ombudsman serves as a facilitator and mediator for the timely resolution of complaints. In addition, the Ombudsman is designated to receive reports of retaliation from state member banks that may stem from an appeal or a complaint.

For any institution supervised by the Federal Reserve that appealed a material supervisory determination, the Board's policy statement directs the Ombudsman to contact the institution six months after the appeal has been resolved to ensure that no retaliation has taken place. The Ombudsman's office is also required to contact the institution six months after the next examination to ensure that retaliation has not occurred. Upon completion of such contacts, if retaliation is reported, the Ombudsman informs the appropriate division director or Board committee.

Reserve Bank–specific Appeal Policies

Each Reserve Bank has established its own policy for processing appeals received from any supervised institutions within the overall framework of the Board guidance described above. For example, each Reserve Bank's policy describes the composition of the independent review panel for its district. Six Reserve Banks' policies go beyond the guidance to require and prescribe specific time frames for determining whether the appeal is complete and clear.

In addition, most of the Reserve Banks' policies state that banks may contact the designated Reserve Bank official or the Board's Ombudsman if they believe that they have been retaliated against. Finally, some of the policies describe disciplinary actions to be taken against Reserve Bank staff in cases of retaliation against a bank that appealed an examination or other material supervisory determination.

Analysis of Frequency and Success of Examination Appeals

According to data provided by the Board, there were 12 appeals from state member banks during the five-year period 2007 through 2011.[18] All 12 appeals pertained to material determinations during safety and soundness examinations; none of the appeals related to consumer compliance examination issues. No appeals were submitted in 2007, and only one appeal was filed in 2008. In 2009, four banks appealed material supervisory determinations, all of which concerned the banks' ratings. Two appeals were filed in 2010: one was related to the bank's component rating for management and the other was related to loan classifications. In 2011, five banks submitted appeals, all related to specific material supervisory determinations, such as allowance for loan

18. The Board received appeals during this period from other entities, such as bank holding companies; however, only state member bank appeals are included within the scope of this audit.

loss, loan classifications, divestiture of bank-owned life insurance, and exclusion of certain preferred stock from regulatory capital.

The 12 appeals reached the following levels in the appeals process:

- 9 appeals were resolved at the Reserve Bank independent review panel
- 1 appeal was resolved at the Reserve Bank President level
- 2 appeals were decided by the appropriate Board Governor

The resolution of the 12 appeals submitted during the five-year period resulted in

- 1 case being completely overturned in favor of the state member bank
- 3 cases with certain determinations upheld and other determinations overturned
- 2 cases being withdrawn
- 6 cases being upheld

We reviewed information from the Ombudsman's office that showed that all state member banks that filed an appeal from 2007 through 2011 were contacted by the Ombudsman as required by the Board's policy and no retaliation was reported. In addition, we found that no complaints of retaliation were filed with the Board's Ombudsman during this period.

IV. Summary

As requested by the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, we conducted an audit of the Board's small community bank examination process. We learned that the Board's examination oversight includes System-wide supervision and communication, detailed examiner guidance, training, and quality assurance. This structure is designed to ensure consistency of state member bank examinations throughout the Federal Reserve System. In addition, we reported on the Board's community bank examination process, which involves a risk-focused approach and emphasizes concise and consistent reporting.

We determined that, on average, Reserve Banks issued examination reports within the time frame required by the CBEM. We found that 93 percent of the Federal Reserve examination reports issued from 2007 through 2011 met the 60-day requirement. Additional analysis revealed that Reserve Bank examination reports for small community banks were issued on a timely basis, regardless of CAMELS composite ratings.

As part of our audit, we evaluated the reliability of the examination data we used. We identified a number of data variances when comparing the examination timeline data to actual data found in examination reports. Consequently, we recommend that BS&R improve controls for verifying the accuracy of data entered into NED.

Our audit also addresses Board-regulated institutions' ability to question examination results through the appeals process and the Ombudsman's program. We found that all 12 Reserve Banks have established appeals policies that follow Board guidance. We identified that only 12 state member banks filed an appeal over a five-year period. For the 12 appeals, 1 was overturned in favor of the state member bank, 3 were partially overturned, 2 were withdrawn, and the remaining 6 were upheld.

V. Analysis of Comments

We provided a copy of our report to the Board's BS&R for review and comment. The Division Director stated that BS&R staff agreed with the summary conclusions in the report. In his response, included as appendix 1, the Director indicated that BS&R has initiated a System effort to strengthen the examination database management reviews. In our opinion, the actions described by the Director are appropriate for the recommendation, and we plan to follow up on the division's actions to ensure that the recommendation is fully addressed.

Appendixes

Appendix 1—Division Director's Comments

BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

August 28, 2012

Mr. Mark Bialek
Inspector General
Board of Governors
  of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Mark:

Thank you for providing us with the opportunity to review and comment on the Office of the Inspector General's draft report of the *Audit of the Small Community Bank Examination Process*. We have reviewed the report and agree with the summary conclusions. The Board of Governors of the Federal Reserve System (Board) small community bank examination process is structured to ensure quality and consistency of state member bank examinations. The report describes a comprehensive and well-structured examination process, but notes some need for improving the accuracy of information in the Federal Reserve's examination database. We continue to review our processes and improve controls around examination data quality. To that end, we initiated a System effort earlier this year to strengthen our examination database management reviews by creating specific data quality measures that will be monitored across all Reserve Banks.

We appreciate your efforts and the professionalism exhibited by your staff throughout this review.

Regards,

/s/

Michael S. Gibson
Director

Appendix 2—CAMELS Rating System

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of the institution's financial condition and operations:

- adequacy of ***c***_apital_
- quality of ***a***_ssets_
- capability of ***m***_anagement_
- quality and level of ***e***_arnings_
- adequacy of ***l***_iquidity_
- ***s***_ensitivity_ to market risk

Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. Composite and component ratings are assigned based on a 1–5 numerical scale. The highest rating, 1, indicates the strongest performance and risk management practices and the least degree of supervisory concern, while 5 indicates the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern.

Composite Rating Definition

The five composite ratings are defined and distinguished below. Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance.

Composite 1

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

Composite 2

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

Composite 3

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

Composite 4

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

Composite 5

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

Appendix 3—Principal Contributors to This Report

Chie Hogenmiller, Project Leader and Senior Auditor

David Horn, Auditor

Michael Olukoya, Auditor

Caroline McNally, Auditor

Timothy Rogers, Senior OIG Manager