BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

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DIVISION OF SUPERVISION
AND REGULATION

SR 19-9

June 3, 2019

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Bank Exams Tailored to Risk (BETR)

Applicability: This letter applies to (1) state member banks without a holding company and with less than $100 billion in total consolidated assets and (2) state member banks affiliated with a top-tier holding company that has less than $100 billion in total consolidated assets.

The Federal Reserve has enhanced its process for determining the scope of the supervisory work performed in safety-and-soundness examinations of community and regional state member banks (SMBs). The enhanced process—Bank Exams Tailored to Risk (BETR)—combines surveillance metrics with examiner judgment to classify the levels of risk at an SMB within individual risk dimensions, such as credit, liquidity, and operational risk. The SMB's examination is then tailored to reflect the levels of risk present and minimize regulatory burden for the bank.

BETR builds on the Federal Reserve's overall risk-focused approach to supervision, whereby examiners and other supervisory staff identify risks to an institution and assess management's ability to identify, measure, monitor, and control such risks. The enhanced process advances risk-focused supervision by:

1. Establishing a suite of data-driven, forward-looking surveillance metrics based on various information sources, including the Call Report, to help classify each risk dimension for a bank into a high-, moderate-, or low-risk tier; and

2. Tailoring examination work programs to align examination staff resources and activities more closely to a bank's risk profile.

The following is a brief description of BETR's objectives, the surveillance metrics used to determine the scope of an examination, the risk-aligned examination work programs, and the implementation of BETR.

Objectives

BETR's primary objectives are the following:

1. Identify an SMB's activities that are low risk and apply appropriately streamlined examination work programs to those areas, thereby conserving supervisory staff resources and minimizing regulatory burden.

2. Identify an SMB's high-risk activities and target them for enhanced supervisory attention, thereby directing supervisory resources to where they are most needed.

3. For the remaining moderate-risk activities, implement examination work programs of average intensity.

Surveillance Metrics

BETR's surveillance metrics gauge the potential for an SMB to experience adverse outcomes, such as highly unfavorable financial trends, significant performance shortfalls, severe losses, or supervisory rating downgrades, over a 12- to 24-month timeframe, and under unfavorable market conditions. As such, the metrics assist examiners in classifying the levels of risk related to an SMB's activities.[1]

For each risk dimension considered by BETR, the metrics classify the corresponding activity of an SMB into one of three risk tiers: high, moderate, or low. Low-risk activities pose the least potential for adverse outcomes to an SMB, while high-risk activities entail the greatest chance of unfavorable results. The following definitions generally apply:

- *High risk:* Under unfavorable market conditions, such activities often lead to adverse outcomes, as described above.

- *Moderate risk:* In unfavorable markets, these activities occasionally result in adverse outcomes.

- *Low risk:* The expected incidence of adverse outcomes is low, irrespective of market conditions.

The surveillance metrics' design features are as follows:

1. *Data-driven:* The information content, or predictive capacity, of the metrics is confirmed via data analysis. This feature involves the estimation and backtesting of the metrics using data from previous banking cycles.

2. *Forward-looking:* The metrics gauge the risk posture of an SMB and its susceptibility to severe losses or substantial underperformance. This feature is supported by estimating the relationship between risk indicators at a given point in

[1] BETR's surveillance metrics are a subset of the "Outlier Metrics" introduced in SR letter 15-16, "Enhancements to the Federal Reserve System's Surveillance Program." See also the *Commercial Bank Examination Manual* section entitled, "Federal Reserve System Bank Surveillance Program."

time and bank performance a year or two later, particularly under unfavorable market conditions.

3. *Granular:* The metrics provide insight into individual risk dimensions. This feature is incorporated by developing the metrics separately for each risk dimension considered.

Surveillance metrics provide examiners with a data-driven starting point for determining the scope of an SMB's examination. In cases where examiners are aware of factors indicating that an alternative risk classification for a particular risk dimension would be more appropriate, they should exercise supervisory judgment and adjust the risk tier during the scoping process. Examiners should then record their rationale in appropriate work papers and plan the examination work program accordingly.

Risk-Aligned Examination Work Programs

Examiners tailor examination procedures to the size, complexity, and risk profile of an SMB. The procedures that examiners perform should focus on developing an appropriate assessment of bank management's ability to identify, measure, monitor, and control risk.

For community SMBs, the scope of an examination work program for a particular risk dimension depends on a bank's risk classification, as follows:

- *High risk:* Examiners apply the full extent of examination procedures and conduct additional work as necessary, including independent verification and transaction testing, in order to reach, support, and document conclusions regarding the level of an SMB's risk exposure and the adequacy of bank management's effort to mitigate and manage risk.

- *Moderate risk:* Examiners apply a subset of examination procedures, with a focus on evaluating an SMB's key risk drivers and financial reports to confirm that risk is moderate. Independent examiner verification and transaction testing are applied to specific areas, but reduced relative to high-risk cases.

- *Low risk:* Examiners apply a smaller subset of examination procedures than for moderate-risk cases, with a focus on evaluating an SMB's key risk drivers and financial reports to confirm that risk is low. Independent examiner assessment of risk management is reduced relative to moderate-risk cases.

Supervisory teams design the risk-aligned work programs for each risk dimension, resulting in procedural templates for general use in the examination process. The degree of differentiation between low-, moderate-, and high-risk work programs directly depends, in part, on the predictive capacity of a risk dimension's surveillance metrics, as confirmed via backtesting.

Examination procedures are often more bank specific for regional SMBs, reflecting their larger size and unique characteristics, with somewhat less emphasis on generalized procedural templates. Nevertheless, streamlined work programs are applied to low-risk activities at regional SMBs, and strong risk alignment is maintained in the examination process overall.

At each examination, the examiner-in-charge confirms the risk classifications on which planned work programs were based and, if needed, adjusts or expands the work programs. If initial discussions with management or additional information obtained during the examination indicates significant weakness in an SMB's risk management or higher than anticipated risk, examiners are expected to modify the examination's scope and work programs accordingly. All examination work programs will continue to include the review and verification of corrective action taken to address any outstanding Matters Requiring Immediate Attention or Matters Requiring Attention.

Implementation

The Federal Reserve has a longstanding practice of allocating, in general, more resources to the review of supervised institutions with high-risk activities, while conserving resources at low-risk cases. By enhancing the Federal Reserve's ability to gauge the risk of a bank's various activities, BETR facilitates a more data-driven approach to the risk tailoring of supervisory work at community and regional SMBs.

Inputs and approaches utilized by the BETR program's surveillance metrics are expected to evolve over time. The risk dimensions covered could change, as well. To help manage and enhance the program as it matures and grows, surveillance analysts assess the appropriateness of the metrics on a quarterly basis and update them as needed. Similarly, supervisory teams maintain and update the risk-aligned examination work programs.

BETR's surveillance metrics and examination procedures are currently in use for credit, capital, earnings, liquidity, market, and securities risk, while metrics and procedures for other risk dimensions, such as operational risk, are in various stages of development and will be deployed as work is completed. The examination staff hours suggested for different risk dimensions and levels are being updated to reflect the BETR program.

In addition to examination scoping, BETR's surveillance metrics also help monitor bank risk profiles between examinations. Examiners and other supervisory staff consult the surveillance metrics on a quarterly basis, watching for early signs of increased risk-taking, both at individual SMBs and across the industry. When the metrics point to emerging high risk, staff should formulate and execute an appropriate supervisory response, which in some cases could entail a bank examination.

Data-driven metrics and timely financial data are important to the Federal Reserve and the implementation of BETR. Accordingly, the Federal Reserve reaffirms the importance and value of banks providing timely and accurate financial information via channels such as the Call Report.

Questions about BETR should be directed to Lily Zheng, Manager, Surveillance – Financial Trends, at (202) 973-6966, or Anthony Cain, Manager, Regional Bank Supervision, at (202) 912-4377. Inquiries may also be submitted via the Board's public website.[2]

Michael S. Gibson
Director

Cross Reference:

- SR letter 15-16, "Enhancements to the Federal Reserve System's Surveillance Program"

[2] http://www.federalreserve.gov/apps/contactus/feedback.aspx.