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RISK-FOCUSED CONSUMER COMPLIANCE SUPERVISION PROGRAM

Introduction

The purpose of the risk-focused, consumer compliance supervision program is to improve the supervisory process by utilizing the System resources devoted to ensuring compliance with consumer banking laws efficiently and effectively. To accomplish this goal, the program directs resources to the areas of state member banks with the greatest compliance risk, while reducing regulatory burden by limiting the review of areas having low compliance risk.

Vital to such a program is the expectation that each state member bank will effectively manage its own compliance risk. Given the current environment of the industry--interstate banking, new technologies, product innovation, and financial transactions growing in size and speed--the supervisory process should primarily focus on: (1) areas that pose the greatest risk to the bank and its customers, and (2) the compliance management processes in the bank that identify, monitor, and manage these risks.

In contrast to the traditional approach that used standardized procedures for all banks and placed emphasis on identifying violations of law, risk-focused supervision relies upon performing risk assessments and tailoring supervisory activities to fit the risk profile of a bank. Risk-focused supervision places a greater emphasis on evaluating the appropriateness of an institution's processes for identifying, measuring, monitoring, and controlling its risk exposure. During risk-focused examinations, an assessment of compliance with all statutes and regulations is made, although the review might not involve transaction testing. Risk-focused compliance supervision applies to both state member banks (SMBs) and foreign banking organizations (FBOs) and involves four key elements:

1. **Consumer Compliance Risk Profile and Supervisory Plan**

   The purpose of the consumer compliance risk profile is to develop and maintain a risk assessment of the organization, including its strengths and weaknesses. Various sources of information will be used in developing the profile including Call Report data, NED System data, examination reports, correspondence, complaints, monitoring information, and contact with the bank. The profile will be used as the primary planning tool for developing the supervisory plan, which will detail examination, monitoring, and outreach activities.

2. **Risk-Focused Examinations**

   Risk-focused examinations are designed to identify a bank's risks and problem areas and emphasize examination planning and risk assessment. Such examinations rely heavily on examiner judgement in evaluating the degree and type of risks at a bank and in the products that it offers. Examiners will review two types of risk—product risk and regulation risk. The relationship between these two risks, which are defined below, will determine the scope and level of review necessary to evaluate a bank's compliance with applicable laws and regulations and assess the adequacy of the bank's policies and procedures.

   Product Risk - the characteristics of a product, such as its newness or complexity, that are likely to affect the probability and impact of noncompliance.

Regulation Risk - the possible consequences of noncompliance with applicable laws and regulations to the bank and its customers.

3. Monitoring

An effective monitoring program is critical to the success of risk-based supervision. All banks are subject to some form of monitoring in the interval between examinations. In order to determine high-risk areas and to update the consumer compliance risk profile when appropriate, examiners must remain abreast of developments that affect a bank's consumer compliance risk profile, such as new products and services, geographic expansion, acquisitions, mergers, and changes in financial condition. In addition, examiners should focus on changes in the bank's risk management systems, including management oversight, audit, internal controls, plans, policies and procedures.

4. Outreach

The purpose of outreach is to promote stronger compliance in a setting separate from the examination and monitoring processes. Outreach should place banks in a better position to improve their self-compliance and monitoring, thereby reducing the potential for violations. Outreach efforts should augment the supervisory process, but they are distinguishable from supervisory visits, whose purpose is to address examination issues.

Consumer Compliance Risk Management Program

A consumer compliance risk management program is the means by which a bank manages the consumer compliance risk inherent in its operations. There are six major elements to an effective consumer compliance risk management program: the oversight provided by the board of directors and senior management, the consumer compliance program structure, policies and procedures, compliance audits/reviews, internal controls, and training. The examiner's evaluation of the consumer compliance risk management program serves as the foundation for the risk-focused scoping process that is conducted in preparation for the consumer compliance examination.

All state member banks, regardless of size, should have a consumer compliance risk management program. A carefully devised, implemented, and monitored program provides the foundation for ensuring a bank's compliance with consumer banking laws and regulations. The formality of the consumer compliance risk management program will typically increase in direct proportion to the bank's asset size and the complexity of its operations. However, the program should be evaluated in the context of the bank's business strategy and organizational structure. For example, a small, independent bank may have an informal compliance program that includes both written and unwritten policies and on-the-job training that is entirely adequate. Such a program would not normally be appropriate for a large, multi-branch bank, which usually requires a more formal program and the devotion of greater resources to maintain a satisfactory level of compliance.

<u>Board of Directors and Senior Management Oversight</u>

Oversight of the consumer compliance program by the board of directors and senior management is essential. The board of directors and senior management should periodically review the effectiveness of the bank's consumer compliance risk management program, including how findings are reported and whether the audit mechanisms in place provide adequate oversight. The quality and timeliness of the information provided to the key decision-makers regarding the bank's consumer compliance program are especially important for assessing the program's effectiveness. The board of directors and senior management must also ensure that sufficient resources have been devoted to the program. The ability to achieve consumer compliance program objectives depends, in large part, on the authority and independence of the individuals directly responsible for implementing the consumer compliance program and for performing audit/review activities, and the support provided by the board of directors and senior management,. The board of directors and senior management also must make certain that consumer compliance weaknesses are addressed and corrective action is taken in a timely manner.

<u>Consumer Compliance Program Structure</u>

Examiners should consider the size and complexity of the bank when evaluating the appropriateness and adequacy of the structure of the consumer compliance program. The duties, responsibilities, authorities, and independence of compliance personnel will depend on the nature, scope, and complexity of bank operations. In more complex institutions, a compliance officer or compliance committee should be appointed with specific responsibilities and authorities. These individuals must be able to cross departmental lines, access all operational areas, and ensure that line management implements corrective action or changes to policies, procedures and products when warranted.

Examiners must assess the qualifications and competency of the bank's consumer compliance personnel. This includes their understanding of bank policies and procedures as well as their technical expertise and ability to devote sufficient time to compliance duties. Frequently, the reporting lines within the bank (i.e. the person to whom the results of compliance reviews are reported, or level to which the results are reported) are indicative of independence. In addition, there should be a mechanism in place for presenting findings of significance to the full board of directors or to a committee of the board. This relationship enables the compliance officer to help the board of directors fulfill its responsibilities.

Policies and Procedures

An effective consumer compliance program will have compliance policies and procedures in place, the formality of which (written or unwritten) depends upon the needs of the bank. Policies provide the framework for procedures and may be used as a reference source or as training material for bank personnel. Comprehensive and fully implemented policies help to communicate the board of directors' and senior management's commitment to compliance as well as their expectations.

The degree to which compliance policies and procedures are formalized is not as important as their effectiveness. This is especially true in smaller banks, where established compliance practices may not be in writing but are nonetheless effective if communicated to the staff and performed on a regular basis.

Procedures should provide personnel with guidance that enables them to complete transactions in accordance with applicable laws and regulations. Such information may include appropriate regulation cites and definitions, sample forms, instructions, and where appropriate, directions for routing, reviewing, and retaining transaction documents. The effectiveness of the procedures in meeting consumer compliance requirements is most important, not the degree of their formality. However, at large banks with many employees and multiple locations, the need for written policies and procedures will be greater.

Compliance Audits/Reviews

Compliance audits, which can be performed by either in-house staff or external personnel, are a tool to help management and staff ensure continuing compliance and identify different risk factors in a bank. Such audits help validate the effectiveness of a bank's internal controls and ensure that staff are following established policies and procedures. Compliance reviews are less comprehensive than compliance audits, but they are conducted more frequently, (e.g. daily, weekly, monthly, quarterly) and are typically performed by the compliance officer or a designated person within the department. They are used to verify compliance on an ongoing basis and serve as an early warning system for the bank. The size of the bank and the scope and complexity of its operations will determine whether a compliance audit or a compliance review is appropriate. In the case of large and/or complex banks, both compliance audits and compliance reviews may be necessary, while a compliance review process will suffice for many small banks.

Compliance Audits

Examiners will assess the quality and scope of the institution's compliance audit work, regardless of whether such work is performed by the institution's employees or by a third party. To carry out this task, examiners should have full and timely access to all of a bank's compliance audit resources, including audit personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. [2] [3]

To determine the proper level of audit coverage, the examiner must have a thorough understanding of consumer compliance risk conditions. A well-administered compliance audit function will identify and report any undue risk conditions (e.g., failure by branch office personnel to follow established policy). In addition, the compliance audit program should include some form of transaction testing, as well as a process to ensure that appropriate actions are taken to address weaknesses and correct violations.

In-house staff may perform compliance audit work, or the bank may use external sources. If in-house staff are used, they should be independent of the area and/or transactions being reviewed. The quality and depth of the bank's compliance audit function must be assessed to determine the extent to which examiners can rely on the results of the audit work conducted. Examiners should begin their assessment by reviewing the bank's schedule of compliance audits or reviews and determining whether the schedule has, in fact, been followed. Similarly, the scope for each audit should be reviewed and a determination made as to whether the scope was followed. This will require a review of the compliance audit workpapers. Finally, the compliance audit findings should be reviewed to see if they were communicated to the board of directors and management and whether required corrective action, if any, was taken.

A review may reveal that the bank has a high-quality audit function, which is an important consideration when establishing the scope of the consumer compliance examination. On the other hand, a workpaper review might reveal that, while the compliance audit program appears satisfactory on paper, it was not actually implemented as planned. This could result in poor coverage for some areas, possible unidentified problems, and insufficient documentation and audit trails. A workpaper review might also identify weaknesses in the quality of the audit performed that could compromise the conclusions reached. Such weaknesses increase the bank's consumer compliance risk and would have a direct bearing on the scope of the examination.

A workpaper review is especially important if the bank uses a risk-based approach to compliance auditing. If both compliance audits and examinations are risk-based, there may have been no transaction testing over an extended period of time for some product lines. In such situations, consumer compliance examiners should consider carefully whether some level of transaction testing is necessary during the consumer compliance examination to make a comprehensive assessment of a bank's consumer compliance risk.

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[2] The report or results of the self-test that a creditor voluntarily conducts (or authorizes) are privileged as defined under §202.15 of Regulation B. The privilege under this section applies to the report or results of the self-test, data or factual information created by the self-test, and any analysis, opinions, and conclusions pertaining to the self-test report or results. The privilege covers workpapers or draft documents as well as final documents.

[2] This is consistent with the policy articulated in SR 97-35 (SUP), page 10, dated December 12, 1997. This SR letter contains the "Interagency Policy Statement on the Internal Audit Function and its Outsourcing."

Compliance Reviews
While many small banks may not have the resources to conduct formal, routine, compliance audits, all banks are expected to have some form of compliance review process in place. The compliance officer may develop the compliance review program, or it can be developed by individual departments or through a collaborative effort. In developing a compliance review program, consideration should be given to issues such as regulatory penalties, past examination findings, past compliance audit or compliance review findings, new or changed regulations, personnel changes, operational or system changes, new product offerings, and unusual or infrequent transactions.

As is the case with compliance audits, the compliance review program should be documented and include a process for handling any exceptions that are identified. Exceptions that are isolated or clerical in nature need only be communicated to the manager of the department. Exceptions that are repeat in nature or that could have significant consequences for the bank should also be reported to the compliance officer or other senior management, depending on the management structure of the bank. Regardless of where the findings are reported, there should be a process in place to ensure that required corrective action, if any, is taken.

Internal Controls

Effective internal controls help to mitigate a bank's consumer compliance risk and should be an integral part of the daily operations of a bank. All levels of bank management are responsible for maintaining an effective internal control system that promotes and validates adherence to established policies and procedures. An effective internal control system not only establishes management and staff accountability, but also helps to ensure the prompt correction of identified problems, and serves to mitigate some of the risk inherent in bank activities.

Internal controls may take several forms, including:

- Independent reviews of specific functions or tasks
- Segregation of duties to create a system of checks and balances
- Controls over default settings associated with highly automated calculation tools
- Verification of data before a transaction is completed
- Appropriate approvals and authorizations
- Periodic transaction testing and reviews of forms and procedures

Examiners should review the adequacy of the internal control system for each department under review. This can be accomplished through a review of the department's established procedures, a review of compliance audit/review workpapers, and through discussions with line management. The examiner's compliance testing should help to determine whether the bank's internal controls are working properly.

Training
Ongoing education of bank personnel is essential to maintaining a sound consumer compliance program. The bank should make all personnel aware of consumer banking laws and regulations that affect their areas of responsibility and should provide training regarding the bank's policies and procedures for those areas.

The adequacy of a bank's training program, like that of its overall consumer compliance program, should be assessed in view of the bank's organizational structure and the activities in which it engages. A more formal training program would be expected at a larger bank that offers complex products or operates several independent offices. Smaller banks that have continuity of personnel and do not have very complex product offerings may find a less formal training program to be adequate.

Consumer Compliance Risk Profile

Advances in technology, intense competitive pressures, and various economic forces have quickened the pace of change in the banking industry and created a more dynamic banking environment. In this environment it is important to identify and understand the consumer compliance risk characteristics of state member banks and to have a supervisory program in place that provides for the ongoing assessment of those risks. Moreover, given the increasing complexity and size of banks, it is important to understand the interplay of risks among supervisory functions and the critical role of effective risk management.[4] Sharing information across supervisory functions will help Reserve Banks gain a better understanding of the totality of risk factors affecting a state member bank. In particular, presenting consumer compliance risk factors in a format similar to that used by other supervisory functions promotes consistency and enables the System to better incorporate consumer compliance risk into a state member bank's overall risk profile. [5]
The risk-focused consumer compliance supervision program requires the development of a consumer compliance risk profile for each state member bank. The purpose of the profile is to provide an overview of the bank's consumer compliance risk, to describe how this risk is managed, and to update the Reserve Bank's consumer compliance supervision plan for the bank. The consumer compliance risk profile consists of four components:

- An institutional overview
- An evaluation of the bank's consumer compliance risk management program and the Compliance Risk Management Rating
- An assessment and rating of the consumer compliance risk related to operational, legal, and reputational risk[6]
- A supervisory plan

The level of detail in each profile will vary, depending upon the size and complexity of the state member bank. In addition, if information relevant to the Consumer Compliance Risk Profile is available in the Reserve Bank in documents developed by other specialty supervision areas, that information may be incorporated in the profile by reference to the appropriate documents.

Consumer compliance risk profiles should be updated in conjunction with each supervisory event (e.g., examination, monitoring event, supervisory visit). Profiles should also be updated whenever material changes are discovered. Such changes could be identified during periodic

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[4] Supervisory functions include Consumer, Information Technology, Safety and Soundness, and Trust.
[5] The policies and procedures discussed here relate to the supervision of state member banks. A separate System policy has been put in place relating to assessing consumer compliance risk in large complex banking organizations (LCBOs) and large banking organization s (LBOs) that are subject to continuous supervision (BHC Framework). This policy relating to state member bank supervision will interrelate with the BHC Framework only when the state member bank is part of an LCBO or LBO.
[6] Safety and soundness examiners rate these three business risks, along with three additional risks – credit, market, and liquidity - as part of their risk-focused examination process. Ratings and the trends in these six risks are then incorporated into a risk matrix. Mapping consumer compliance risk into these three risk categories (operational, legal, and reputational) will ensure that consumer compliance risk receives appropriate consideration in the development of the state member bank's overall risk profile.

contact with the bank. While such contacts are optional, they often prove useful in ensuring that consumer compliance risk profiles are accurate and current, particularly with regard to large or problem banks.

A discussion of the four components of the consumer compliance risk profile follows. At a minimum, each risk profile must contain these four components, with other factors added as appropriate. Appendix I contains a template that provides detailed guidance on the information needed for each section of the consumer compliance risk profile, and Appendix II lists the different sources of information that may be used to develop the Institutional Overview and Consumer Compliance Risk Management Program sections of the profile. These data sources should be consulted before contacting the bank for the information.

Institutional Overview

This overview should include a discussion or summary of the following:

- The bank's organizational structure, including whether the bank is owned by a bank holding company, the degree of operational centralization, and any subsidiaries with activities relevant to the bank's consumer compliance risk. Also, significant or planned structural changes (e.g., mergers, acquisitions, divestitures, pending applications) that could have an impact on the bank's consumer activities since the last supervisory event.
- The geographic areas or markets served by the bank, including a statement as to whether the bank is an interstate bank, and a listing of the states, Metropolitan Statistical Areas (MSAs), and Federal Reserve districts in which it operates
- The bank's business strategies including key business lines, delivery channels (e.g., electronic banking), product mix, new products, marketing emphasis, and growth areas
- Significant consumer compliance or CRA supervisory issues or concerns
- Other important supervisory issues (e.g., enforcement actions, financial condition) encompassing all supervisory functions that could have an impact on consumer compliance risk
- Any pertinent consumer complaint activity
- Any substantive litigation or other legal concerns related to consumer compliance issues

Consumer Compliance Risk Management Program

This section of the profile should include a description and evaluation of the following six elements[7]:

- Board of directors and senior management oversight
- Consumer compliance program structure
- Policies and procedures
- Compliance audits/reviews
- Internal controls
- Training

The Consumer Compliance Risk Management Program section should also include the assigned Compliance Risk Management Rating (CRMR). This rating should reflect the examiner's assessment of the overall effectiveness of the six elements of the consumer compliance risk

[7] Refer to the section, "Consumer Compliance Risk Management Program," for a detailed discussion of each of these six elements.

management program. The CRMR does not replace the consumer compliance rating assigned at the completion of a consumer compliance examination.[8] Although there may be some overlap in the factors considered when assigning the two ratings, the CRMR focuses solely on the bank's consumer compliance risk management program. In most cases, the existence of a strong or satisfactory consumer compliance risk management program will influence the nature and extent of violations identified during an examination and, consequently, the ratings may be the same. In other instances, the CRMR may differ from the consumer compliance rating depending on the cause of a violation, the isolated or repeated nature of a serious violation, or the fact that the CRMR is updated during a monitoring event.

The CRMR, which is based on a scale of 1 through 5, in ascending order of supervisory concern, should be consistent with the following criteria:

<u>Rating 1 (Strong)</u>
A rating of 1 indicates that management effectively identifies, monitors, and controls all major types of consumer compliance risk posed by the bank's activities, including those from new products and changing market conditions. The board of directors and management take an active role in managing consumer compliance risk and ensuring that appropriate policies and procedures exist and receive board review and approval. The bank's consumer compliance management program is appropriately structured for the scope and complexity of its operations. Policies and procedures, internal controls, and audit procedures are sufficient and appropriate for the size and activities of the bank. Employee training is timely, effective, relevant.

<u>Rating 2 (Satisfactory)</u>
A rating of 2 indicates that the bank's management of consumer compliance risk is largely effective. This rating reflects a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the bank's business plan. Board of directors and senior management oversight, consumer compliance program structure, policies and procedures, compliance audits, internal controls, and training are considered effective in maintaining satisfactory consumer compliance. Modest weaknesses or deficiencies may exist, but they are correctable in the normal course of business. Generally, risks are controlled in a manner that does not require additional or more than normal supervisory attention.

<u>Rating 3 (Fair)</u>
A rating of 3 indicates that consumer compliance risk management practices are lacking in some important ways and, therefore, are cause for more than normal supervisory attention. One or more of the six elements of sound consumer compliance risk management show weaknesses that require improvement. Further, these weaknesses may preclude the bank from fully addressing a significant risk to its operations or may prevent management and the board of directors from identifying, monitoring, and adequately controlling all of the bank's significant consumer compliance risks. If uncorrected, the identified weaknesses could have an adverse effect on the consumer compliance level of the bank.

<u>Rating 4 (Marginal)</u>

[8] The Federal Reserve uses the Uniform Interagency Consumer Compliance Rating System to assign consumer compliance examination ratings.

A rating of 4 indicates marginal consumer compliance risk management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board of directors. Several elements of sound consumer compliance risk management are considered marginal and require immediate and concerted corrective action by the board and management. A number of significant risks to the bank have not been adequately addressed, and the consumer compliance risk management deficiencies warrant a high degree of supervisory attention. Unless properly addressed, these deficiencies could seriously affect the bank's level of consumer compliance.

Rating 5 (Unsatisfactory)
A rating of 5 indicates a critical absence of effective consumer compliance risk management practices designed to identify, monitor, or control significant risk exposures. Typically more than one of the six elements of sound consumer compliance risk management is considered wholly deficient, and management and the board of directors have not demonstrated the capability to address deficiencies. These deficiencies may seriously jeopardize the consumer compliance level of the bank and they require immediate and close supervisory attention.

Consumer Compliance Risks Applicable to Safety and Soundness
This section should describe consumer compliance risk characteristics in a manner consistent with the way risks are evaluated by safety and soundness examiners. The consumer compliance risk profile incorporates an assessment of operational, legal, and reputational risks arising from a bank's consumer compliance activities. These risks are defined as follows:

- Operational Risk is the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses
- Legal Risk is the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a bank
- Reputational Risk is the potential that negative publicity regarding a bank's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions

The risk assessment identifies whether the level of each risk is High, Moderate, or Low and assigns a trend indicator of Increasing, Stable, or Decreasing. The risk assessment considers two elements: 1) the level of inherent risk involved in each of the bank's significant business activities, and 2) the strength of risk management systems in place to control the level of risk in these activities, which has already been assessed in determining the CRMR. An activity that contains inherently higher risk may nevertheless be deemed acceptable if this risk is appropriately controlled through a strong system of internal controls and processes.

Appendix III was developed to help examiners determine the appropriate risk level for operational, legal and reputational risk. It is important to recognize that the appendix does not represent a complete list of issues that should be considered when assessing each risk category. In addition, a particular item could have an impact on one or more risks. As a result, examiners are expected to exercise judgment when using the guidance in Appendix III to assign a rating.

Supervisory Plan

The supervisory plan establishes the framework of supervisory events for the bank (e.g., examinations, supervisory visits, monitoring events) and the schedule of those events. The CRMR should be considered in determining the nature, extent, and timing of future supervisory events. A decline in the CRMR and/or in the risk assessment for operational, legal, and reputational risk could warrant a change in the schedule of supervisory events (e.g., moving up the date of the next monitoring event or consumer compliance examination). As applicable, consumer examiners should identify areas for review, but need not set out the planned examination procedures to be completed (which would be addressed in the examination scope memorandum). The level of detail in the supervisory plan will vary depending upon the size and complexity of the bank. At a minimum, the plan should include the following supervisory events, along with their anticipated timing:

- Examination (if earlier or later than required, a brief summary of the reasons for the change should also be included)
- Monitoring event
- Outreach efforts
- Other periodic contacts (optional)

The consumer compliance risk profile should be shared with other supervisory functions, other Reserve Banks, and other regulatory agencies, as appropriate. If the bank is part of an LCBO or LBO, the consumer compliance risk profile should be used by the consumer compliance examiner in developing the consumer compliance risk assessment described in the BHC Framework.

Examination Planning Activities

The examination planning process should result in the identification of the information necessary to establish an examination's scope in accordance with the risks posed by a bank's particular activities. It is critical that this process begin far enough in advance of the examination to allow sufficient time to request and review the information necessary to develop the scope of the examination, thereby also enabling examiners to perform more of the scoping review off-site. Identifying risks in advance also results in more efficient examinations and reduces time spent in the bank, thereby reducing regulatory burden. In addition, advance planning helps to facilitate the exchange of data between the Reserve Bank and state member bank. It also helps to identify and allocate necessary resources and tailor the first-day letter, which requests material needed on the first day of the examination.

Information Gathering

Reserve Bank staff should review information about an institution from both internal and external sources in constructing the scope of an examination. The following is a list of documents and sources that, among others, may be helpful in this process.

Information at the Reserve Bank:

- Reports of Examination for compliance, commercial, trust, and information systems
- Workpapers of the previous compliance examination
- Scope memoranda for commercial examinations
- Commercial supervisory plan (for large complex institutions, or others, as available)
- CRA Public Evaluation
- UBPR and Call Reports
- Monitoring report, including changes since the most recent examination
- Complaint and correspondence files
- Prior corrective actions
- Community demographic data
- Previous years' HMDA LARs
- CRA small business and small farm report data
- Consumer compliance risk profile
- Content of the bank's website

Information from State Member Bank or FBO:

- Audit reports, management responses, and internal controls
- Training programs
- Changes in compliance management and personnel
- Changes in policies, procedures, and standards since the prior examination
- Description of Management Information Systems
- Current year HMDA LAR data
- Information about changes to bank's Internet activity
- Interviews with bank management and staff

Examiners may obtain this information through either formal (letter or questionnaire) or informal (telephone conversation) requests of the bank.

First-Day Letter

In addition to requests for examination-planning material, the Reserve Bank may send a first-day letter requesting that specific information be available on the first day of the examination. The first-day letter should be tailored to fit the character and profile of the institution to be examined as well as the needs of the Reserve Bank. To eliminate duplication and minimize regulatory burden on an institution, first-day letters should not request information that is provided to the Reserve Bank on a regular basis such as annual reports or Call Reports.

When preparing the first-day letter, the examiner should consider the following when deciding what information should be forwarded to the Reserve Bank for off-site review versus that which should be ready for examiners upon their arrival at the bank:

- Risk-focused supervision objectives and the examination scope. Do not include items that are not needed to support selected examination procedures
- Efficiency in the examination process and reduction in burden on financial institutions.
- Minimize the number of requested items and avoid, to the extent possible, duplicating requests for information already provided to the Reserve Bank – including information provided by the bank to other specialty areas and to other agencies
- Whether the information is confidential or is not easily reproduced by the bank. Certain materials could be reviewed on-site (e.g., policies, corporate minutes, audit work papers, special management reports)
- Time needed for bank management to prepare the requested information.

Scoping Activities

Types of Risk

The goal of a risk-focused examination is to direct resources toward areas possessing higher degrees of risk. To accomplish this goal, the examiner must review two types of risk -- *product risk* and *regulation risk*. The relationship between these two risks will determine the scope and level of review necessary to evaluate a bank's compliance with applicable laws and regulations. A discussion follows of product risk, regulation risk, and the levels of review.

<u>Product Risk</u>

Product risk measures risks associated with a product that are likely to affect the probability and impact of noncompliance. The institution's products and services may present *low*, *moderate*, or *high* risk to the bank depending upon the interplay among four key characteristics: product management, product materiality, product stability, and bank size or market share. It is important to remember that aspects of one characteristic may influence another. These four characteristics are described below.

1. Product Management

   Product management relates to the bank's ability to identify, monitor, and manage the compliance risk inherent with a particular product. Essential factors to consider include: knowledge and expertise of the product management team, effectiveness of internal controls (e.g., use of checklists) adequacy of policies and procedures, adequacy of resources, adequacy of the consumer compliance risk management program (e.g., training, compliance reviews), recent compliance history (e.g., violations noted at prior examinations and recent audit findings), record of consumer complaints, effectiveness of audit coverage, and management's ability to respond to change (e.g., changes in regulations, systems, and products). Systems and controls are more heavily weighted compared to the other characteristics, given that they reflect management's inclination and ability to manage product risk.

2. Product Materiality

   Product materiality reflects the importance of a product as compared to other products offered by the bank. Materiality may be measured by dollar volume, activity volume, or both. Changes in the portfolio mix between examinations may also be important. Materiality should be considered to ensure that examination resources are directed to those product lines most significant to the financial institution. In some cases, more than one product may be material to the bank. The examiner should bear in mind, however, that an evaluation of product materiality is intended to identify the bank's core businesses and shift examination resources and efforts in that direction.

3. Product Stability

   Product stability is an assessment of such characteristics as the newness of the product, growth of the product, any complex compliance issues associated with the product, automation used to comply with applicable laws and regulations, and any recent changes to the statutes or regulations affecting the product. For example, credit card products that are newly offered at a bank may reflect higher risk because of the new and complex nature of the business. Alternatively, products with unchanged characteristics and a strong record of compliance management may reflect low stability risk.

4. Bank Size or Market Share

A bank's size or market share serves as a proxy for the number of consumers potentially affected by a bank's activities. Generally, banks with assets of less than $250 million represent lower risk in this regard, while those with assets of more than $1 billion are higher risk. There may be instances where the market share of a product line, rather than the absolute size of the bank, may be the best indicator of the impact on consumers. For example, a bank with assets of less than $250 million may dominate a rural market in one product. In such a case, it may be appropriate to increase the consideration given to the bank size or market share in order to reflect its dominant market share of the product. Conversely, wholesale banks are typically large when measured in terms of total assets but often have relatively small consumer impact; such cases may warrant a lower risk consideration for this characteristic.

Regulation Risk

Regulation risk measures the possible consequences to the bank and its customers of noncompliance with specific regulatory provisions. Regulation risk recognizes that the impact of noncompliance differs depending on the consumer law or regulation. For the public, it is the measurement of relative financial harm that noncompliance may produce. For the bank, regulation risk is the measurement of legal, reputation, and financial harm that noncompliance may produce. For example, the financial harm both to the bank and to consumers associated with violations of the Truth in Lending Act (Regulation Z) requiring reimbursements far exceeds the consequences of an isolated undocumented check hold.

The assignment of a regulation risk rating might be affected by such factors as:

- Potential financial harm to consumers
- Potential legal, reputation, and financial harm to a bank
- New laws, regulations or amendments thereof
- Historical industry compliance
- The burden of corrective action, including potential supervisory actions or civil liability that could lead to monetary penalties.

On an annual basis, Board staff, with Reserve Bank participation, will evaluate consumer protection laws and regulations and update the risk rating for each statute, regulation, or specific provisions of each. The updated Regulation Risk table will be distributed to Reserve Banks at the conclusion of each annual review.

Levels of Review

Regulation risk and product risk are to be integrated to determine the scope and level of review necessary to verify the bank's compliance with applicable laws and regulations. While compliance with every statute and regulation will be reviewed to some degree during every examination. The amount of transaction testing, if any, will, however, depend on the level of review required. A description of these levels follows:

Level I Review

Examiners must, at a minimum, complete a Level I review of each regulation during every examination. A Level I review uses a "top-down" approach and includes an assessment of the bank's policies, procedures, internal controls, audit and management reports, and interviews with bank personnel. It also includes a review of any bank forms introduced or modified since the last examination.

A Level I review also identifies potential internal control weaknesses or operating deficiencies that may increase the risk of noncompliance with consumer laws and regulations. When such weaknesses are identified, the examiner must determine whether the level of review of that particular area should be increased to a Level II or Level III review.

Level II Review

A Level II review consists of a Level I review and limited transaction testing using a judgmental sample. The amount of sampling is dependent upon the adequacy of management processes. If internal systems are considered reliable, examiners should select only enough transactions to validate to their satisfaction that the systems are effective and accurate. Conversely, if internal management systems were deemed unreliable or ineffective, then the examiner should determine if a larger sample is necessary or if a Level III review should be conducted.

Level III Review

A Level III review involves statistical sampling. Examiners should assess the need for a Level III review based on, at a minimum, the results of a Level I review. A Level II review may also indicate the need for a Level III review. A Level III review is used when it is considered necessary to fully assess the level of compliance in an activity or function being tested. See page 31 for a discussion of statistical sampling.

Scoping Procedures

Examiners establish the scope of an examination by translating product risk and regulation risk into the levels of review required for each product. When preparing the necessary documents, examiners must provide support for the level of review selected.

There are three steps in the scoping process:

- Completion of the Product Risk Tables (discussed below)
- Application of the resulting scores to the Examination Matrix (discussed below)
- Development of the Product Modules (optional – see page 20 for details).

Product Risk Table

The Product Risk Table provides a means for determining the risks associated with a particular product or product groups having similar characteristics. Examiners must complete these tables for every product line offered by the bank. While the procedures envision grouping products with similar characteristics, examiners should avoid creating overly broad categories. For instance, one single product group designation for all deposit products is too broad. A more logical grouping, for determining materiality or assessing internal controls, may be two categories: transaction and nontransaction accounts.

When completing the product risk tables, examiners must consider the types of services and products the bank offers, as well as the bank's organizational structure. For example, certain services, such as electronic banking, may be more accurately categorized as a business line. In addition, a review of the similarities or differences among the products within a business line may help examiners determine which product lines to examine. Moreover, because a lack of internal controls might have a greater adverse effect on one particular product than another, it is important for the examiner to address the increased risk within the confines of the product adversely affected.

Product Risk Table

PRODUCT RISK TABLE				
	PRODUCT:			
	LOW	MODERATE	HIGH	COMMENTS
PRODUCT MANAGEMENT	2	4	6	
PRODUCT MATERIALITY	1	2	3	
PRODUCT STABILITY	1	2	3	
BANK SIZE OR MARKET SHARE	1	2	3	
TOTALS:				
TOTAL RISK SCORE:				

For each product or product group, the examiner will assign a risk rating and corresponding numerical scores of Low, Moderate, or High to each of the four product characteristics. (Examiners should rate the risk relating to product management low only if the bank's system of internal controls includes independent transaction testing.) In addition, each rating should be fully supported by a brief statement placed in the Comments section, below the table, or in the scope memorandum. Comments may include references to information contained in the bank's consumer compliance risk profile.

Regulation Risk Table

The following table depicts consumer laws and regulations by risk level:

REGULATION RISK TABLE		
RISK	**Statute/Regulation**[9]	**Section (s) for review**
Low **1**	Real Estate Settlement Procedures Act (Reg X) Right to Financial Privacy Act Fair Debt Collection Practices Act Unfair or Deceptive Acts or Practices (Reg AA) Rule of 78s	Mortgage Servicing Transfer Disclosure All All All All
2	Expedited Funds Availability (Reg CC) Truth in Savings Act (Reg DD) Reserve Requirements (Reg D) Fair Credit Reporting Act Consumer Leasing (Reg M) Interest on Deposits (Reg Q)	All All All All All All
3	Real Estate Settlement Procedures Act (Reg X) Truth in Lending Act (Reg Z) Electronic Funds Transfer Act (Reg E) Reg. B and FHA Provisions	All provisions except those rated "1" and "4" All provisions except those rated "4" All Provisions not covered by FFIEC interagency procedures
4	Truth in Lending Act (Reg Z) National Flood Insurance Act (Reg H) Privacy (Reg P) Real Estate Settlement Procedures Act (Reg X)	APR/Finance charge, HOEPA, and rescission All All Section 8
5 **High**	HMDA and CRA	Data verification

[9] Compliance with the provisions of the Community Reinvestment Act (Regulation BB), other than those relating to data verification, and Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 will be fully reviewed at each CRA examination and, therefore, are not included in this table. In addition, issues related to discrimination (Regulation B and FHA), which will primarily be reviewed through the use of the FFIEC interagency procedures, are not included in this table.

Examination Matrix

The Examination Matrix is used to determine the level of review required for each product given the product risk score and regulation risk.

EXAMINATION MATRIX			
Regulation Risk	**Product Risk Score**		
	Low (5-6)	**Moderate (7-11)**	**High (12+)**
Low 1	**Level I**	**Level I**	**Level II**
2	**Level I**	**Level I**	**Level II**
3	**Level I**	**Level II**	**Level III**
4	**Level I**	**Level II**	**Level III**
High 5	**Level III**	**Level III**	**Level III**

Establishing the scope of an examination may indicate the need to review different parts of the same product at different levels of review. For example, with regard to mortgage loans, mortgage servicing transfer disclosures have a regulation risk of 1, while APRs have a regulation risk of 4. If the product risk score for mortgage loans is Moderate or High, the necessary level of review for the two will differ (i.e. if the product risk score is Moderate, a Level I review is required for the mortgage servicing disclosure, while a Level II review is required for the APR). Therefore, the examiner would employ Level I review methods (such as reviewing the bank's policies and procedures and conducting interviews with bank management) to verify compliance with the mortgage servicing transfer disclosure requirements. The examiner would then select an appropriate sample for transaction testing (Level II) to verify the accuracy of the APRs.

Product Module

The Product Module is a tool to organize and document the appropriate level of review for the regulations affecting a product.

PRODUCT MODULE				
Levels Of Review	**PRODUCT:**			
	Applicable Regulations:			
	Reg.______	**Reg.______**	**Reg.______**	**Reg.______**
LEVEL I				
LEVEL II				
LEVEL III				

Use of the Product Module is optional, but is recommended for products subject to multiple regulations, such as home mortgage loans.

Selection of Business Lines or Products

Examiners should identify the business lines or products that will be reviewed during an examination based on an analysis of factors such as the transaction volume and market share. Examination resources should be focused on main business lines, as well as key credit products and core deposit services offered by the bank.

In larger or more complex institutions, with multiple processing centers or a wide variety of similar products such as mortgages, a "business line" approach to examination planning may be appropriate. Based on high transaction volumes and the need for highly specialized management systems, some institutions have segmented their products and operations into self-contained independent units. Typically, a business line organizational structure will include a specialized system of internal controls as well as a dedicated compliance and audit infrastructure to serve the needs of the particular business or its products. The examination plan should take into account the degree of specialization, level of control and overall impact of potential non-compliance when deciding the scope of the review based on a business line structure. In addition, the examiner should be sure to include a representative selection of products that reach the banks overall markets through its various delivery channels.

In finalizing the selection of business lines, products, or products within a business line for review, the examiner may also wish to consider grouping products according to their similarities to increase examination coverage and focus examination resources.

Selection of Branches

Selecting branches to review will depend largely on the bank's organizational structure, operational procedures, product offerings, and marketing strategies, as well as the length of time since a particular branch was last reviewed. In addition, factors including market share, lending volume, and location of branches, such as those in or near low- or moderate-income areas or Indian reservations, should also be considered when determining which branches should be scheduled for review. The scope memorandum should include a discussion of the rationale for branch selection, scope of branch reviews and sampling strategy, as appropriate, to ensure adequate coverage of branch disclosures, transactions, and operations.

The degree to which the bank's operations are centralized and controlled by the main office will also influence the number and scope of branch reviews. Banks with centralized operations generally will require fewer branch reviews, and those reviews should focus on high risks such as those associated with initial disclosures or prescreening. In addition, the on-site review should assess the branch personnel's knowledge, understanding and compliance with consumer laws and regulations and bank policies. On-site reviews should normally be conducted at a representative number of branches, as measured either by loan application activity or size of the deposit base.

Branches of banks with decentralized loan and deposit operations, however, may require a broader scope and increased depth of review to assure adequate examination coverage. The increased scope and depth of these reviews will depend largely on the level of head office control and consistency of branch policies and procedures. Generally, a decentralized branch operation, with strong internal controls, consistent standardized policies and procedures and a strong management reporting system may not warrant a review more than that which is appropriate for branches in a centralized operation.

However, branches in a decentralized operation, which do not receive a high degree of head office control or do not exhibit a strong control environment may warrant a review similar to that of an independent bank. This level of review would involve a more thorough basic examination, including review of policies and procedures, forms, interviews with branch personnel, and an analysis of a sample of loans and deposit products, as appropriate. In these types of operations, examiners may wish to select a larger number of branches to assure adequate examination coverage.

Section 109 Review

In planning an examination, the examiner should determine whether the bank has any interstate branches that are covered by Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. While the examination procedures do not require visits to a covered branch, the examiner should determine whether a Section 109 review is required, and the results of the determination should be noted in the scope memorandum. A brief mention that a determination was made and a Section 109 review was, or was not, required is sufficient.

Scope Memorandum

The scope memorandum identifies the key objectives of the examination and should be prepared after a review of all relevant information. Besides the examination objectives, the scope memorandum should include a description of on- and off-site activities and the level of review for each product as indicated by the examination matrix. The rationale for the sample size of products or regulations designated for transaction testing should be included, as well as the reason(s) a particular branch was chosen for review.

In most cases, the completion of the Product Risk Tables and Product Modules, supplemented with narrative comments, will suffice. The institution's consumer compliance risk profile should be a key reference item for the scope memorandum. In limited circumstances, the examiner-in-charge may feel that a level of review other than that indicated by the examination matrix is more appropriate. In these cases, a detailed discussion of factors warranting review at an alternative level must be included in the scope memorandum. <u>These cases should be the exception, not the rule.</u>

The scope memorandum may also include resource information such as anticipated hours, expenses, or previous examination hours. In any case, the scope memorandum must include a discussion of the examiner resources required, including supporting documentation such as the bank's responses to examination planning questions, any subsequent correspondence, the examination matrix, and other forms or information that support the examination program.

To ensure consistency in the scoping process, Reserve Bank management <u>must</u> implement an approval process that includes a review of the final scope memorandum. An officer or other supervisory personnel deemed appropriate by Reserve Bank management should perform this final review prior to conducting the examination. This review and approval should be documented.

An addendum to the scope memorandum should be prepared to document any material changes in the original scope that occur during the examination (including decisions to change the sample size or change the level or review), but it is not necessary to update the scope memorandum with the examination conclusions. These conclusions should be documented elsewhere in the workpapers.

General Examination Instructions

Initial Meeting with Management

Upon arrival at the bank, the examiner should meet with senior management and the compliance officer to discuss the nature and scope of the examination. Because the issues identified in the scoping process and the suggested level of review typically change from examination to examination, it is important to provide bank management with an understanding of the risk-focused examination process and how it will be applied to their bank. The overview of the examination may include the number or names of branches selected for review, the levels of review for particular loan or deposit products, and specific areas to be evaluated during the examination. Given the sensitivity of the issues, it may also be helpful to discuss the fair lending portion of the examination and the focal points that have been identified for it. Finally, management should be informed that, while the scope of the examination may be adjusted for some areas, all of the consumer banking laws and regulations will be reviewed.

Potential Regulation B or Fair Housing Act Discrimination

Procedures for Notifying the Board

If it appears that the bank is discriminating, the facts should be reviewed with Reserve Bank management, and Board staff should be notified immediately in accordance with CA 93-10 (dated December 27, 1993) and CA 95-2 (dated June 30, 1995). Occasionally, the examiner or Reserve Bank management may have questions of a statutory, regulatory, or interpretive nature. If so, staff should discuss the issues with their assigned Review Examiner in the Board's Division of Consumer and Community Affairs. If a response from Board staff is delayed, the examiner should indicate to bank management that additional research is needed to resolve the specific compliance issue and that a response will be forthcoming as soon as those issues are resolved. The report of examination, containing this caveat, may be issued.

Corrective Action Required

When a determination is made that policies or procedures resulted in discrimination or had a discriminatory effect, bank management should be advised of the nature and extent of the nonconforming practice. Management will then be required to change the practice to eliminate any discriminatory effects. Corrective action must comply with the requirements of the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts as well as the Board's referral policies detailed in CA 93-10 and CA 95-2. Corrective action could involve the retraining of all affected personnel including brokers, dealers, appraisers, and anyone else acting as agent on the bank's behalf.

Final Discussion

Purpose

The objective of the final discussion is to summarize examination findings and obtain, when necessary, management's commitment for corrective action. The examiner-in-charge should discuss the findings of the examination with management and, to the extent appropriate, personnel involved in consumer compliance activities. (Reserve Bank management should be apprised of these findings prior to the final meeting with the bank.) The final discussion should focus on substantive violations, required corrective action and recommendations, and the overall condition of the bank's compliance and CRA programs (if applicable). Management should be asked to explain the specific steps that will be taken to eliminate violative practices to the extent possible during this discussion, so that its intentions can be included in the report of examination. Occasionally, because of the complexity or severity of the violations, management may not be able to give an immediate detailed response regarding corrective measures. A delay may result as well when involvement from the board of directors becomes necessary. When delays occur, the examiner should reemphasize the need for timely corrective action. The examiner should provide management with a list of all violations noted, included those deemed isolated.

<u>Board of Directors' Involvement</u>

The Board of Directors has the ultimate responsibility for operating the bank in compliance with the law and for ensuring that appropriate corrective action is taken. As a result, when examination findings include serious matters, the board should be apprised of the violations, the importance of their timely correction, and the board's role in the corrective process. The size of the bank and the nature of the violations may dictate the extent of board contact necessary. For example, in a small, closely held bank where the bank president also serves as the chairman of the board, it may be sufficient to include the bank president and possibly one other board member, rather than all board members, in the final discussion meeting. A meeting with the total board may be appropriate, however, if the violations involve severe administrative and civil liability or if the Reserve Bank is contemplating issuing a formal supervisory action, such as. a Written Agreement or a Cease and Desist Order. Typically, a member of Reserve Bank management should attend an examination-related meeting involving the bank's board of directors.

<u>Other</u>

1. Isolated Violations

   As noted earlier, during the final discussion meeting examiners should provide bank management with a list of any isolated violations that will not be included in the written examination report. The bank should be directed to correct the violations and to revise its procedures and forms to prevent future violations of a similar nature (see Consumer Affairs Report of Examination, below, for additional information).

2. Ratings

Although formal disclosure of any numeric rating to a bank's board of directors is communicated in the examination report, examiners may provide bank management with their recommended rating at the exit meeting. The examiner should explain that the recommendation is subject to change and is not final until approved by Reserve Bank management. Bank management should also be informed that the examination report or transmittal letter may request a detailed response to the report of examination and, if necessary, the Reserve Bank will follow up with additional communication to ensure that appropriate corrective action is taken, when appropriate.

3. Benefits of Regulatory Compliance

It is important to discuss the benefits of regulatory compliance with management, relative to the bank's overall customer service strategy. Banks can integrate compliance into a broader strategy of customer relations and customer service so they can foster the loyalty of consumers. By doing so, the examiner can provide sound advisory assistance.

Sampling Procedures

NOTE: When reviewing for compliance with fair lending regulations and statutes, refer to separate sampling guidelines in the section of this Handbook that covers fair lending examination procedures.

The risk-focused program uses two types of sampling methodologies: judgmental sampling and statistical sampling. Judgmental sampling is used for all Level II reviews, while a statistical sample is used for Level III reviews. Both of these sampling methods and their uses are described in more detail below.

Judgmental Sampling

All Level II reviews require judgmental transaction testing. This testing involves sampling a nominal number of disclosures, files, or accounts to determine compliance with the regulation under review. A sample should consist of the minimum number of files the examiner believes necessary to verify compliance.

The entire group or "universe" from which the sample is chosen should have similar characteristics. When verifying an institution's compliance with a particular area, it is important that the examiner, not the bank, select the transactions to be reviewed. Sample sizes and individual samples chosen should not be left to the discretion of the financial institution. Examiners should document the rationale for the sample sizes selected. Examples of factors that might affect sample sizes are:

- Size of sample relative to size of "universe"
- Nature of institution's operations (centralized vs. decentralized)
- Problems found in previous/current audits
- Volume of activity at various branches
- Quality of bank's internal controls for the product being reviewed.

Judgmental sampling, like statistical sampling, involves an in-depth analysis of only a portion of a group. The basic purpose of sampling is to enable an examiner to draw adequately reliable conclusions about a "universe" by testing only a portion of the items in that universe. One feature that distinguishes judgmental from statistical sampling is that each item in the universe does not have an equal chance of being selected by judgmental techniques. Items are not selected randomly in a judgmental sample because a predetermined hypothesis is the subject of the tests. Consequently, the items in the sample are ones deemed likely to confirm or refute that hypothesis. The exception to this rule arises when an examiner tests computations performed by an automated system. Since an automated system provides uniformity, unless there have been program changes since the previous examination, only a few items need to be tested on a judgmental basis, as they will be representative of the "universe."

1. Size of Judgmental Sample

Because statistical validity is not a major issue for this type of sampling, the ideal size of a judgmental sample cannot be stated in terms of numbers. Instead, the size of the judgmental sample depends on the complexity of the regulation(s) involved, the bank's circumstances, and the characteristics associated with each of the bank's products. There are two keys to judgmental sampling. First, the sample must contain enough items for the examiner to conclude, with an adequate degree of assurance, that the bank is in compliance with the applicable statute or regulation. Second, the sample must be large enough for the examiner to determine the cause and extent of noncompliance, in the event that violations are found. As a result, examiners should carefully consider past examination findings when determining the contents and size of a sample. Examiners should also be prepared to expand the sample, if necessary. For example, if overcharges are found, a larger sample may be necessary to assess the extent of such overcharges.

2. Period of Time

The time period selected for the sample must yield enough items to give the examiner a representative base for the bank product under review. If there are too few items in the sample the examiner may need to extend the time period of the sample.

Changes that occurred since the last examination, such as the bank's purchase of a new computer system for calculating various disclosures, may also necessitate extending the time period. For example, if a new computer system was installed a month before the examination, a "reasonable" sampling time period may target disclosures calculated prior to, and subsequent to, the use of the new system and related program. However, if the previous examination occurred two years earlier and the new computer system was implemented a year later, the examiner should not normally sample loans made prior to the computer system installation unless there is a specific reason for doing so. The same principle applies to reviewing changes in management, policies, or key personnel.

3. Sample Selection

There are no predetermined or established methods for selecting a judgmental sample. In general, the items selected should be similar in type (such as real estate loans) and contain the specific characteristic being tested (such as real estate loans with points.)

Statistical Sampling

A Level III review involves statistical sampling. Statistical sampling is most effective when used to compare one item with a definite standard. For example, Regulation B requires an adverse action notice to contain certain information. Statistical sampling could be used to select a sample of adverse action notices to determine if they contain the required information. This type of sampling is recommended for high-risk banks, or instances in which judgmental sampling has revealed extensive problems.

The following examples reflect areas where statistical sampling may be particularly useful. This listing, however, is not intended to be all-inclusive. The examiner may determine that statistical sampling is appropriate for other regulations as well, if extensive problems are discovered.

Regulation B
- Monitoring information on applicable real estate applications
- Timing of adverse action notices

- Content of adverse action notices
- Retention requirements
- Application (separate or joint) compared to note (individual or cosigned)

FCRA
- Applicable disclosures

RESPA
- Use and retention of the HUD-1
- Use of the Good Faith Estimate
- Use of the Special Information Booklet

Regulation Z
- All applicable disclosures

Regulation H – Flood

The Federal Reserve System uses numeric sampling, which enables the examiner to predict, with an adequate amount of assurance, how often a particular "found" violation exists in the universe of relevant transactions. In order for a particular sampling exercise to be effective, however, all items in the sampled universe must have the same basic characteristics and must have an equal chance of being selected.

When choosing a sample, an examiner should consider the following:

1. *Number of samples.* The number of statistical samples that are needed will be determined by reference to a number of factors. For example, the universe of transactions from which a sample is drawn must consist of items that are essentially uniform or have the same basic characteristics. Therefore, although a bank's portfolio of car loans may have the same characteristics, car loans may not have the same characteristics as single-pay loans because the repayment times and underwriting criteria may be different. As a result, the different types of loans and related documents must be sampled separately.

   The number of separate samples, consequently, is dependent upon the number of separate universes that the examiner has identified for review. In some banks, the number of samples will be fairly easy to determine. In other banks, such as decentralized banks with a large number of branches, the number will be determined by factors discussed in the Planning Activities section.

2. *Period of time covered.* Sample periods chosen should target the bank's current procedures. Consequently, each universe should consist of items that have been fully processed in a recent 30-day period proceeding the date of the examination. If necessary, the 30-day sample period should be extended back to a date that will allow for a representative sample of lending activities, such as lending across branches, decision centers, and loan types.

3. *Sample size.* The size of the sample is proportionate to the number of items in the universe of transactions. The "number in universe" refers, for example, to the total volume of applications received, loans granted, or records generated in the 30-day sample period. Many banks use a numbering system or generate reports reflecting the current loan volume. These reports can be helpful in selecting a sample.

   The following chart depicts the number of sampled items required under the System's numeric sampling procedures. These sample sizes provide, with a 90 percent assurance rate, that if no violations were found in the sample, violations in the universe probably would be nonexistent or minimal. Sample sizes outlined in the chart should be applied to each category or universe of transactions.

Number in Universe	Size of Sample	
	Minimum	Maximum
1 – 99	20 or total universe if smaller	20
100- 299	20 plus 10% of number above 100	40
300- 499	40 plus 7% of number above 300	54
500-749	54 plus 6% of number above 500	69
750- 999	69 plus 5% of number above 750	82
1,000-1,999	82 plus 4% of number above 1,000	122
2,000-2,999	122 plus 3% of number above 2,000	152
3,000-4,999	152 plus 2% of number above 3,000	192
5,000-9,999	192 plus 1 1/2% of number above 5,000	267
10,000-or more	267 plus 1% of number above 10,000	

Expanding the Sample

Whether the examiner has performed transaction testing using a judgmental or statistical sample, there may be instances when the examiner concludes that it would be appropriate to expand the sample. For example, assume a review of real estate loans reveals understated APRs, and that the examiner suspects the cause of the problem was the bank's failure to include points as part of the finance charge. While the examiner knows a violation exists, the root cause or extent of the violation is not known. Consequently, to determine the cause and extent of the violations, the examiner should develop a hypothesis that would then be tested in a judgmentally expanded sample. For example, the hypothesis may be that "all disclosure statements involving points prepared by a certain individual are incorrect". The expanded sample would consist of disclosures involving points prepared by the individual in question. When using this method, enough files should be reviewed to either confirm or refute the hypothesis.

HMDA Data Sampling

In connection with each examination, examiners should check the bank's HMDA data for accuracy. Since institutions are required to record each quarter of loan activity on the LAR within 30 days after the end of the quarter, every examination conducted after April 30 each year should include a judgmental review of accuracy of the current year's HMDA data.

In addition, the examiners should review for accuracy HMDA data for each year that has been submitted since the previous examination. For banks that submit limited data and for which data is not relied upon in conducting the fair lending or CRA examination, the product module and examination matrix may indicate a Level II review, involving sampling as appropriate. In these instances, examiners should choose a judgmental sample that is sufficiently large to ensure confidence in the overall accuracy of the data. Whenever HMDA data are relied upon to complete the fair lending or CRA examination, the relevant product should be rated Moderate or High Risk and Level III examination procedures should be used.

For most institutions, inaccurate data precludes completion of the CRA or fair lending portions of the examination. Therefore, when possible, Reserve Banks should schedule the HMDA data verification in advance to allow for resubmission of any inaccurate data.

Selecting a statistical sample of HMDA data requires the examiner to use a two-tiered sampling method (described in Appendixes IV and V) that allows examiners in certain circumstances to stop their file review after a minimal number of files are reviewed. For example, if a HMDA LAR universe contains 150 files, a total random sample of 56 files should be taken. The examiner may begin the file review by inspecting 29 files. If no more than one file had any errors in any key fields[10] in this review, the examiner could stop the file review after the 29 files were completed.

However, if between two (2) and five (5) files were found to have one or more errors in key fields, the examiner must continue reviewing the 27 additional files, for a total sample size of 56 files. After completing the review of the total sample of 56 files, the examiner should determine the total number of files with key field errors and apply the System's resubmission policy (see Appendix VI) to the entire sample, if necessary.

If, however, with a universe of 150 files the examiner finds six (6) or more files with an error or errors in key fields during the review of the initial 29 files, the examiner should stop the review. If this is the case, sufficient statistical evidence has been obtained to conclude that a larger sample would have an unacceptable error rate, thus requiring resubmission of the data. At this point, the examiner should apply the System's resubmission standards to the total sample.

After analyzing the errors found during the sampling process, examiners may choose to perform supplemental targeted random sampling. For example, after completing a review of a HMDA sample, an examiner may discover that errors appeared to be arising from one particular loan decision center or are most prevalent in a particular product type. The examiner might decide to select a supplemental random sample of HMDA records specifically tied to that loan decision center or loan product. In these instances, supplemental samples should follow the same sampling process as with the original sample, utilizing the two-tier approach described below.

The statistical validity of this approach relies upon review of a <u>random sample</u> from each HMDA reporter's entire LAR, as well as a review of information year by year using separate transaction universes for each year. This sample approach should only be used for HMDA verification purposes due to the statistical method employed in the sample table design. It should not be used for other examination sampling purposes.

[10] Key fields are: loan type, loan purpose, owner occupancy, loan amount, action taken type, MSA, state, county, census tract, applicant race, co-applicant race, applicant sex, co-applicant sex, and income.

Reporting Examination Findings

Introduction

The Consumer Affairs (CA) Report of Examination is the official record of the examination and the primary tool for conveying examination findings to bank management. This report should be used for all consumer compliance and CRA examinations.

The risk-focused examination approach focuses on the bank's high-risk areas as well as its business strategies and compliance risk management processes. Consistent with this approach, the report focuses on the ***evaluation*** of the procedures and processes a bank has in place to identify, measure, monitor, and control its compliance risk. While the primary focus is the evaluation of procedures and processes utilized by the bank to ensure compliance, substantive violations are also important. To provide bank management with an understanding of the issues, violation write-ups should include a discussion of the cause and severity of the violations along with any discussion of what the regulation or statute requires. Likewise, conclusions regarding the bank's compliance risk and the quality of its compliance program should reflect a thorough analysis supporting the conclusion.

To ensure that management and the directors will not misunderstand or misinterpret the examination findings, the report should ***clearly*** and ***concisely*** communicate examination ratings, material findings, supervisory issues, and any needed corrective action. Moreover, report comments should be well documented in the workpapers.

Report Format

The report consists of an open section provided to the bank and a confidential section utilized by the System. Reserve Banks are free to modify the report to reflect unique situations or to adapt the format to reflect its own programs. At a minimum, however, the open section should include the following:

- Table of Contents
- Executive Summary and Examination Ratings
- Scope of Examination
- Evaluation of the Compliance Management Program
- Evaluation of Fair Lending
- Violations of Laws and Regulations (if applicable)
- CRA Assessment (if warranted)

All report-related documents **must** conform to Board Information Security Manual ("ISM") classification requirements. Generally, report-related documents will be classified as **Restricted F.R.** (Details regarding the Board's ISM policy are discussed in the ISM Manual.)

Timely transmittal of examination-related documents is an important part of the examination process. CA examination reports and CRA public evaluations, where applicable, should be mailed to state member banks, foreign banking organizations, and the Board no later than 60 calendar days following the close of an examination. As part of this process, the Reserve Bank should send copies of the following to the Board:

- Report of Examination
- CRA Public Evaluation
- Scope Memorandum for fair lending
- Scope Memorandum for the other areas of the compliance examination
- Consumer Compliance Risk Profile
- Transmittal Letter
- Community Contact Sheets
- Pertinent correspondence for banks rated “3,” “4,” or “5”

Relevant information should be entered into CARES on the same date the examination report and CRA public evaluation are transmitted to the Board and the bank. A copy of the report should also be forwarded to the relevant State banking department. The Reserve Bank should retain a copy of the examination report in its files, along with any relevant correspondence.

<u>Open Section</u>

Table of Contents

The Table of Contents highlights the important findings of the examination. If necessary, Reserve Banks may modify the Table of Contents to reflect unique situations or adapt the format to reflect their own program. At a minimum, however, the Table of Contents should include the following sections and their corresponding page numbers in the report:

- Executive Summary and Examination Ratings
- Scope of the Examination
- Evaluation of the Compliance Management Program
- Evaluation of Fair Lending
- Violations of Law and Regulations (if applicable)[11]
- CRA Assessment (if warranted)

[11] It is not necessary to include in the table of contents an exhaustive list of all consumer banking statutes and regulations reviewed during the examination. To focus attention on the most important examination findings, only those statutes and regulations with substantive violations should be listed under the Violations of Laws and Regulations section in the Table of Contents. For example, if a bank was not subject to Regulation M, then that regulation would not be listed in the Table of Contents. Likewise, if the bank was subject to Regulation M, but no violations related to that regulation were included in the report, Regulation M would not appear in the Table of Contents.

Executive Summary and Examination Ratings

The Executive Summary provides a brief overview of the examination report findings. The effectiveness of this page depends on the accuracy, brevity, and clarity of presentation. When complex issues or other matters arise, the summary should discuss the general nature of these matters in a few sentences and refer the reader to the appropriate section of the report for a more in-depth discussion.

This section of the report contains the bank name and date of examination, a list of Reserve Bank and state member bank officers and staff attending the exit meeting, and a discussion of the following matters:

- Examiner's conclusions regarding the bank's compliance and CRA programs and applicable ratings
- Significant issues and required corrective action
- Recommendations (if applicable)

Each of these areas is discussed in more detail below:

1. Examiner's Conclusions Regarding the Bank's Compliance and CRA Programs and Applicable Ratings

   This section includes both the compliance and the CRA ratings, along with their accompanying standardized descriptions from the Interagency Consumer Compliance Rating System. In addition to the ratings, this section includes a brief description of the effectiveness of the bank's compliance program and the primary factors that contributed to the assigned compliance and CRA ratings. A statement characterizing the bank's level of compliance with the Equal Credit Opportunity Act (Regulation B), and the Fair Housing Act should also be included.

   When discussing the compliance or CRA ratings, ambiguous phrases should be avoided. For example, rather than a vague statement such as "Compliance rating of 1 is considered to be strong," a more comprehensive description of the rating should be provided to bank management. The description should include a discussion of the principal factors that make the program strong and contribute to the "1" rating. Examples might include the bank's commitment to consumer compliance, management participation in the compliance program, effective internal procedures and controls, review mechanisms, and staff training.

2. Significant Issues and Required Corrective Action

   This section discusses significant issues discovered during the examination, along with any required corrective action. Significant issues may include any matter that exposes the institution to increased risk, such as discrimination or substantial understatements of the APR or finance charge. For example, if an examination revealed violations of the Truth in Lending Act that required a file search and reimbursements, those violations should be discussed and the corrective action clearly identified. Additionally, any specific follow-up activities to be undertaken by the Reserve Bank should be discussed here as well.

3. Recommendations (if applicable)

   This section includes material recommendations discussed with bank management during the exit meeting. If appropriate, this section may be combined with the previous section so that recommendations can be paired with their corresponding significant issues.

   Recommendations are not mandatory corrective actions to be undertaken by the bank to address deficiencies. Instead, recommendations are suggested enhancements to strengthen the bank's compliance or CRA programs. Consequently, recommendations should be as specific as possible. A report with no recommendations is preferable to one with overly broad suggestions such as "The bank should continue its commitment to an effective compliance program."

Scope of Examination

The Scope of Examination section contains the following:

- Compliance areas reviewed
- CRA examination method (small bank or large bank)
- Statement that CRA community contacts were made (do not include names)

While the name of the bank and the date of the examination may also be included, this information is not necessary if it is included in the Executive Summary.

Evaluation of the Compliance Management Program

In addition to evaluating the effectiveness and comprehensiveness of the bank's compliance management program, this section should also discuss any significant changes in the bank's level of compliance since the last examination. Overall, the discussion should support the examiner's conclusions regarding the compliance rating assigned to the bank. Comments in this section should also offer more than a description of the bank's compliance management program. Rather, they should be evaluative in nature and discuss the following factors, but only to the extent that they affect the examiner's conclusions.

1. Bank Management and Board of Directors' Oversight

   This section evaluates bank management's ability, knowledge, and commitment to complying with consumer protection banking laws and regulations. For example, does management exhibit the leadership and administrative abilities necessary to facilitate and ensure compliance? Is management able to interpret, understand, and implement consumer laws and revisions to such laws, or does management rely heavily on examiners for guidance in understanding consumer protection laws and regulations? Does management keep abreast of changes in laws and regulations? Does management have a positive attitude regarding compliance?

A discussion of the level and quality of oversight provided by the board of directors to bank management, particularly regarding the operation of the bank's compliance program, should also be included here. For example, does a review of board minutes reveal consideration of compliance issues? Are the directors aware of their liability? To whom does the compliance officer report? Does the compliance program adequately address the risks associated with the applicable consumer protection laws and regulations?

2. Consumer Compliance Risk Management Program

This section discusses the adequacy and scope of the bank's compliance management program. At a minimum, examiners should consider the following matters when evaluating the compliance management program. Only those aspects relevant to the evaluation, however, need to be addressed in the examination report.

a. Organizational Structure

- Is the bank's organizational structure appropriate for the size and complexity of its operations?
- Does the bank have a compliance officer? If not, why not? If yes, to whom does the compliance officer report, and what level of compliance expertise does he or she possess?
- How independent is the compliance officer? Does he or she have the authority to make necessary changes?
- How comprehensive is the bank's compliance program?
- How much time does the compliance officer devote to regulatory compliance? Is it sufficient?
- Does the bank's compliance officer operate a proactive or reactive compliance program? Is it sufficient?
- How have changes in personnel or automated systems affected the bank's level of compliance?

b. Policies and Procedures

- Does the bank have formal or informal, written policies and procedures?
- Do the policies address the compliance management and audit functions?
- Do policies and procedures provide employees with enough information to do their jobs effectively?

c. Compliance Audit/Internal Controls

- Does the bank have an audit program? If yes, how effective is it?
- Is the audit an internal or external audit? Is it formal or informal?
- Is the compliance program included in the scope of the bank's audit/review function?

- Are the results of the audit communicated to the board of directors and senior bank management?
- Are exceptions corrected in a timely manner?
- Does the audit program include transaction testing? If so, how comprehensive is the testing, and what is the frequency: daily, weekly, monthly, quarterly?
- How does the presence (or lack) of an audit program contribute to (or detract from) the effectiveness of the bank's compliance program?
- Does the bank's legal counsel review bank forms and procedures for compliance?

d. Training

- Does the bank's training program address changes to consumer protection laws and regulations, and to policies and procedures?
- Is training provided to all relevant bank staff?
- Is training provided in a timely manner?

Evaluation of Fair Lending

This section includes a discussion of the scope of the fair lending examination, an evaluation of the bank's fair lending program, and the examiner's conclusions regarding the level of fair lending compliance. Comments concerning the scope of the fair lending examination should briefly discuss the following areas:

- Type of analysis (such as underwriting or pricing)
- Time period reviewed
- Product(s) reviewed
- Market(s) reviewed
- Decision center(s) reviewed
- "Prohibited basis" group(s) reviewed
- Sample sizes

This section should discuss violations of the anti-discriminatory provisions of Equal Credit Opportunity Act/Regulation B and the Fair Housing Act (FHA) and should contain any advisory comments deemed necessary. The discussion of the violations should include the names of loan applicants found to be victims of illegal discrimination.

Violations involving other provisions of Regulation B and the FHA usually involve procedural aspects of these regulations and should be discussed in the Violations of Law section of the examination. Likewise, violations of the Home Mortgage Disclosure Act and the Fair Credit Reporting Act should also be presented in the Violations of Law section and not in the Fair Lending section of the examination report.

Violations of Laws and Regulations (if applicable)

While all regulatory violations are important, the examination report should direct management's attention to those violations that represent the highest degree of risk to the bank or its customers and to those that require immediate corrective action. Violations included in the report of examination are often characterized by one or more systemic, or procedural weaknesses. Such violations usually affect or could affect, a large number of transactions or customers. Violations that represent repeat deficiencies or a condition or practice that, when combined with other regulatory violations, reflects unfavorably upon the effectiveness of a bank's consumer compliance risk management program should also be included in the report of examination. Moreover, violations that have severe consequences to the consumer, such as discrimination are generally included in the report of examination. Depending on the nature and type of discrimination, one instance may be considered serious enough to necessitate including it in the report.

Isolated violations that are inadvertent errors or that are not indicative of bank practice are not generally included in the report of examination. The existence of a large number of isolated violations, however, may indicate weaknesses in a bank's consumer compliance risk management program and, when considered together, could elevate the violations to a more serious level, which may in turn necessitate inclusion in the examination report. Examiner judgment and a thorough understanding of the circumstances surrounding the violations are critical in determining whether they should be included in the report.

All violations, regardless of whether they are included in the report of examination, should be discussed with bank management, thoroughly documented in the examination workpapers, and entered in CARES.

1. Organization of Violations

   This section of the report may be organized by regulation or statute, or by function (loan or deposit type), branch, or in any other logical order. Whatever method is used, the aspects of the bank's activities with the most significant violations should be listed first. For example, if the violations of Regulation Z were the most important finding, then those violations should be listed first. Likewise, if the findings were organized by function, and credit card violations were the most significant, this area should be listed first.

2. Description of Violations

   The scope of the review for a particular regulation or statute should be discussed before the violations for that regulation or statute are presented. This discussion may include a listing of what the examination reviewed (e.g., policies, procedures, disclosures, or other matters), the number of loans sampled, and a short summary of the examiner's findings. Comparisons to the last examination may also be included here.

   To draw attention to the violations, a citation to the relevant statute or regulation should be highlighted. This may be done by placing the cite in the margin, at the beginning of the discussion, or on a line above the discussion. It is not necessary to begin a new page for each regulation or statute.

The discussion of a violation should include:

- A description of the problem, the extent of the problem, and how the bank's situation differs from the law's requirement or prohibition
- The cause of problem, if it can be determined
- Required corrective action, recommendations, and the bank's response (if available).

It is not necessary to specify corrective action for a particular violation if corrective action is implicit in the description of the violation. Appropriate recommendations should include suggestions for improvements to the bank's internal controls and procedures or changes to the bank's disclosure forms. It may also be appropriate to give broad recommendations in the Recommendations section of the Executive Summary, rather than in the discussion of individual violations.

CRA Assessment (if applicable)

This section of the report is limited to information related to the bank's CRA performance that is not suitable for the CRA Public Evaluation. This section is **not** a reiteration of the information contained in the performance evaluation and should not be included in the report if there is no relevant information to be discussed.

This section should begin with the statement "The discussion of the bank's CRA performance in this examination report supplements the public performance evaluation. To obtain an understanding of a bank's overall CRA performance, the CRA examination summary report must be read in conjunction with the public evaluation."

Information in this section may include, but is not limited to, lending restrictions, supervisory actions that have not been made public, or comments regarding Reserve Bank follow-up activities.

Confidential Section

The primary purpose of the Confidential Section of the examination report is to provide Reserve Bank and Board staff with confidential or administrative information. This information is not shared with management of the bank. As a result, the confidential pages of the examination report are not included in the report transmitted to the bank. The confidential section of the report includes information about the bank's compliance and CRA performance deemed unsuitable for the open section of the report. Information known to the bank, discussed in the open section of the report and, therefore, not deemed to be confidential to the System should <u>not</u> be included in this section.

Pertinent Examination Information

This section must include:

- The current compliance rating and CRA rating, including date(s)
- The previous compliance rating and CRA rating, including date(s)
- The name of the examiner-in-charge
- A list of other examiners participating on the examination
- Information, such as tentative bank plans or strategies that may affect the scope or conduct of the next compliance examination or other issues to be targeted or considered for review during scoping, monitoring, or other future supervisory events
- CRA-related information deemed unsuitable for the open section of the report, such as tentative bank plans or strategies that may affect the scope or conduct of the next CRA examination
- A listing of community contacts made as part of the CRA examination
- Material deemed unsuitable for the open section of the report because of privacy issues
- The amount of time devoted to each phase of the fair lending portion of the examination
-

With respect to information necessary for monitoring, scoping or other future supervisory events, examiners may include comments on outstanding or recommended enforcement actions, recommended Reserve Bank follow-up activities, a target date for the next examination or supervisory event, recommended interim advisory visits, and suggestions for the focus of future examinations.

With respect to fair lending examination time, examiners should allocate hours using the following categories: offsite (pre-examination planning, scoping, and sampling), and on-site (file review, comparative analysis, pricing analysis, and regression analysis).

Other Relevant Information

If fair lending violations are discovered, this page should include a discussion of any pertinent information not included in the open section of the report. For example, if the open section of the report includes an advisory comment regarding Reserve Bank concerns that did not result in violations, related confidential information should be summarized in this section.

The Confidential section may also include statements that have a bearing on the bank's overall compliance level or position. Examples of this might include anticipated changes in certain management positions, ownership of the bank, or the effect of potential reimbursements on the bank's capital. If appropriate, comments on this page could also include the names of individuals or other sources responsible for substantive violations. Finally, information on pending consumer litigation that might affect the bank's level of compliance may also be included here.

Transmittal Letter

While Reserve Banks may exercise discretion in the format of their correspondence with state member banks and FBOs, the following may provide useful advice in drafting portions of the transmittal letter.

Significant Issues

The letter transmitting the examination report should draw attention to the most significant issues identified in the report's Executive Summary. To this end, the letter should include the compliance and CRA ratings, as applicable. If corrective action is required as a result of an examination, the transmittal letter should identify a specific timeframe or due date by which the bank must detail and forward to the Reserve Bank an explanation of the actions it plans to take, or has taken. The transmittal letter should also request supporting documents, when warranted.

Requiring a response to the examination report, however, is not always necessary. For example, if the examiners discover a few minor violations during the examination but no major issues that need to be addressed, no response from the bank would be necessary. If the bank takes corrective action on the violations identified during an examination before the conclusion of the examination, and if the examiner confirms the corrective action and notes it in the report, a formal response to that aspect of the report would not be necessary.

Timing and Availability of CRA Public Evaluation

The transmittal letter should also include information regarding the timing and availability of the bank's CRA public evaluation, and the bank's opportunity to include in its public file any comments it may have with respect to the public evaluation.

Small Bank Monitoring Program

All banks are subject to some type of monitoring in the interval between examinations. The objective of the monitoring program is to evaluate the operational, structural or environmental changes between examinations that might affect a bank's overall compliance risk. The monitoring program requirements differ based on the size of the bank. The details of the monitoring programs for small banks and large banks are discussed below.

<u>Overview</u>

The Small Bank Monitoring Program complements the System's examination program for state member banks with assets of less than $250 million and CRA ratings of either Satisfactory or Outstanding. The objective of the program is to evaluate the operational, structural and environmental changes between examinations that could affect a bank's overall compliance risk indicator or compliance rating.

The monitoring event is to be conducted within three months of the midpoint of the examination cycle (e.g., 24 months for banks with Satisfactory CRA ratings or 30 months for banks with Outstanding CRA ratings).[12] A monitoring event consists of three primary activities: (1) answering the questions contained in the Monitoring Guidelines, (2) completing a Monitoring Risk Grid, and (3) evaluating the bank's compliance rating. Each of these activities is described below.

<u>Monitoring Guidelines Questionnaire</u>

The Monitoring Guidelines (Appendix VII) include a number of questions that must be answered in order to determine whether a bank likely remains qualified for a compliance rating of at least satisfactory. The questions apply to at least one of the three dimensions listed on the Monitoring Risk Grid (Appendix VIII): (1) Management, Strategy & Organizational Structure; (2) Products & Services; or (3) Fair Lending. Examiners should answer as many questions as possible using information available at the Reserve Bank.[13] Other questions will require contact with the bank, either by telephone, through a monitoring questionnaire, or an onsite supervisory visit.

When completing the section of the Monitoring Guidelines questionnaire devoted to fair lending, the examiner should focus particularly on whether risks are stable and whether an onsite visit to review loan files, conduct interviews, etc. is necessary. The review to answer the questions related to fair lending in the Monitoring Guidelines can be completed offsite with respect to banks that are HMDA reporters or banks that have already been examined under the interagency fair lending examination procedures and will provide detailed loan data to the Reserve Bank. If, however, the offsite review indicates deterioration in the bank's fair lending compliance posture, an onsite review must be conducted. Likewise, an onsite review is required for banks that are not subject to HMDA, and those that cannot provide sufficiently detailed loan data. The onsite review should include analyses of loan

[12] Banks with compliance ratings of 3, 4, or 5 or CRA ratings of Needs to Improve or Substantial Noncompliance are subject to full compliance examinations every 12 months; as a result, no monitoring activities at routine intervals are prescribed for these institutions. The monitoring of these institutions should be tailored to their specific circumstances.
[13] Internal sources of monitoring information include: the bank's compliance risk profile; BHC Inspection Report; Consumer Affairs, Commercial, Trust, and Information Systems examination reports; NED; correspondence files; consumer complaints files; Uniform Bank Performance Reports; and HMDA LARs.

files, adverse action notices, the geographic dispersion of approved and denied applications, comparative file reviews, and other procedures the examiner deems appropriate.

Monitoring Risk Grid

A Monitoring Risk Grid (Appendix VIII) must be completed as part of each monitoring event after all of the questions in the Monitoring Guidelines have been answered. Information gathered from the questionnaire, from contact with the bank, or from an onsite visit must be evaluated to determine the compliance posture of the institution, the level of risk evident in its operations, and whether the risk is decreasing, stable, or increasing. If an onsite visit is conducted, the Monitoring Risk Grid should be completed while the examiner is onsite and used to determine whether a more rigorous onsite supervisory review should be conducted, including a risk-focused examination, if necessary.

Risk ratings on the Monitoring Risk Grid should be assigned using the same principles described in the "Scoping Activities" section of this guidance. A risk of "Moderate" and "Increasing" or higher in two or more dimensions would generally warrant a supervisory visit. A risk of "High" and "Increasing" in two or more dimensions would generally warrant conducting a full risk-focused examination. These guidelines represent the minimum requirements for a monitoring program and do not preclude a Reserve Bank from conducting onsite supervisory visits as a regular part of its monitoring program.

If the grid indicates that a supervisory visit is warranted, and the examiner is not already onsite, an onsite review should be conducted as soon as practical after the determination is made. The scope of the supervisory visit, including any transaction testing, should be based on the dimensions illustrated as most critical in the Monitoring Risk Grid. If the onsite review reveals that the bank has not maintained a satisfactory compliance posture, a risk-focused examination must be conducted as soon as feasible. Information gleaned from this monitoring effort may also give the examiner cause to call for an earlier CRA examination as permitted by the statute.

Evaluation of the Bank's Compliance Rating

At the completion of the monitoring activities, including an onsite supervisory visit, if necessary, the examiner must determine whether the bank's compliance program is likely to warrant at least a satisfactory rating were a complete examination to be conducted. If the examiner determines from the information reviewed and other examination routines undertaken that the bank's compliance rating, in all likelihood, would be at least satisfactory were a full examination conducted (compliance rating of 1 or 2), a letter should be sent to the bank indicating that its compliance program remains at least satisfactory. If however, the monitoring activities cannot support a conclusion that the bank's compliance posture remains consistent with at least a satisfactory compliance rating, a complete risk-focused consumer compliance examination must be conducted and a new compliance rating assigned.

Documentation of Monitoring Activities

The analyses and conclusions developed as a result of these activities must be adequately documented and supported in a set of workpapers retained by the Reserve Bank. In addition, the conclusions drawn from this process should be considered when establishing the scope, timing, and staffing of subsequent examinations, and could result in an amendment of the Reserve Bank's overall supervisory plan for a bank. In addition, the consumer compliance risk profile (including the compliance risk assessment, if appropriate) should be updated upon completion of these monitoring activities. A brief explanation should be included describing any operational, structural, or environmental changes that indicate a possible change in the bank's consumer compliance risk profile.

Outreach

Approach

As discussed in CA 98-10, the basic premise with regard to outreach is that the more informed state member banks become about the regulatory environment in which they operate, the greater the opportunity for them to achieve compliance on their own. Therefore, the goal of the System's outreach activities is to provide state member banks with timely and consistent information regarding consumer compliance regulatory and supervisory matters. As state member banks become more proficient at addressing their compliance responsibilities, consumer compliance examinations can be streamlined and better focused on high-risk or problematic areas. This approach will ultimately allow for more efficient use of examiner time and resources, as well as reduce regulatory burden.

Because each Reserve Bank is somewhat unique in organizational structure, different approaches may be taken with regard to allocation of resources and personnel for developing and delivering compliance outreach activities. There is also the potential for overlapping efforts to occur on certain issues in Reserve Banks that have separate and distinct compliance examination and community affairs functions that both engage in outreach activities. To avoid overlapping and duplicative efforts, it will be critical that there be good communication and coordination efforts between these units, including cooperative efforts, where feasible. In any case, however, the people who conduct the compliance outreach activities must be experts in regulatory compliance and supervisory matters.

Program Development

Outreach programs should be tailored by Reserve Banks to meet the needs of state member banks in their respective districts. A key part of this process is identifying the information needs of those banks. It is very important that each Reserve Bank survey or assess the needs of its state member banks before designing and developing an outreach program. In general, though, it is suggested that the program focus on providing information pertaining to consumer compliance matters, emerging compliance supervision issues, legislative and regulatory changes, changes in technology and product delivery systems, new product developments, and anything else that is, or may be, a consumer compliance concern for state member banks.

Potential Outreach Activities

An essential element of a successful outreach program is the regular performance of needs assessments. A needs assessment is used to identify the information needs of state member banks in order to better design outreach efforts which effectively address those needs. Utilizing the needs assessments, each Reserve Bank should select from among the outreach activities listed below, or others of their own devising, to provide outreach assistance to state member banks. The outreach activities considered most important are listed first.

1. Advisory Visits – Make advisory visits to individual, or a group of, state member banks to discuss timely regulatory and supervisory issues with management. These visits should be separate from, and outside of, the supervisory process and used only as an opportunity for an exchange of

information and ideas. However, the bank should be required to correct any violations discovered during an advisory visit.

2. Seminars – Sponsor seminars on new regulations and consumer compliance developments for state member banks. Seminars should, for example, focus on the System's interpretation of regulations or compliance-related developments, any experience gained from examinations, and guidance to state member banks to help them avoid compliance problems. They may also be designed to "best practices" information and, to the extent possible, measures to help prevent commonly cited violations. Reserve Banks may also produce videotapes of seminars, when possible, to address these purposes.

3. Telephone Access – Establish and communicate the availability of a telephone number at each Reserve Bank for bankers to call regarding regulatory compliance matters.

4. Internet Access to Information – Disseminate compliance-related materials and other information to state member banks via the Internet.

5. Compliance Materials – Share existing compliance outreach and educational information among Reserve Banks for distribution to state member banks. Development of new compliance-related materials, going forward, should be shared among the Reserve Banks, as appropriate.

6. Industry Schools and Conferences – Speak or teach at compliance schools and conferences throughout the country in order to disseminate information and heighten both the visibility of our efforts and the accessibility of System personnel.

7. Interagency Information Sharing – Meet periodically with the FDIC, OCC, OTS, and state banking agencies to share information and to seek opportunities to jointly sponsor educational seminars for bankers.

8. Survey Banks – Provide a quality assessment form with each examination report, allowing bankers the opportunity to comment on the supervisory process and on the quality of the examination. This, in turn, can feed the development of outreach information and activities.

9. Educational Material for Directors – Develop educational materials on consumer banking laws and regulations for directors of state member banks.

10. District Newsletter – Develop and distribute a newsletter to state member banks focusing solely on consumer compliance and CRA-related topics. This type of communication vehicle could also generate feedback from bankers concerning other issues, further facilitating ongoing dialogue.

Examination Workpapers and Checklists

While the traditional examination approach used standardized procedures for all banks and focused on identifying violations of law, the risk-focused approach concentrates on performing risk assessments and tailoring the examination to the risk level of an individual bank. As a result, documents and information not required before, such as scoping memos and information explaining the level of review performed on-site and off-site, are now integral parts of System workpapers. On the other hand, the completion of examination checklists and standard workpapers, formerly required under the Board's traditional examination approach, is now required only where the risk profile calls for that level of detail.

Workpaper Guidelines
These guidelines represent the minimum workpaper requirements for consumer compliance examinations. Each Reserve Bank is expected to have more specific workpaper procedures and documentation standards to augment these minimum requirements. The compliance examination workpapers serve to explain and document completed examination procedures, violations, and other findings, and provide reference information for use during interim supervisory activities and subsequent examinations or enforcement proceedings. In addition, the Board, the Board's Inspector General, or the General Accounting Office may review and rely on a Reserve Bank's examination workpapers to evaluate supervisory activity. Finally, the Department of Justice may rely on System examination workpapers in connection with its casework.

These minimum guidelines should also be used, as appropriate, for interim monitoring and other supervisory activities. All examination workpapers, however, must comply with the secure handling of confidential supervisory material requirements set forth by the Board and the respective Reserve Bank.

Workpaper Standards
At a minimum, the compliance examination workpapers must:

- Identify the examiner responsible for preparing the workpapers
- Identify the bank personnel responsible for providing information or documents to the examination team
- Include a copy of the scope memo and any addendum that identifies risks, including the levels of review, sampling rationale, and branch selection criteria
- Document the level of review performed for both the off-site and on-site examination activities and the examination activities undertaken to achieve this level of review, including sample sizes, pertinent information about accounts sampled, and other information that documents the type of review conducted
- Document the examination findings, (including copies of disclosures, calculations, violations, analyses, interviews, and conclusions), so that they may be reviewed for accuracy and reconstructed, if necessary

- Identify the examiner responsible for the initial review of the workpapers
- Be organized so that each element of the examination may be understood.

The importance of well-documented workpapers to the System's compliance examination program cannot be overestimated. Supporting documentation is necessary to ensure that compliance examination workpapers provide complete information, support the risk assessment presented in the scope and planning documents, and support the examiner's conclusions for each section of the examination. Complete and properly documented workpapers must contain sufficient information to enable an experienced examiner, having no previous connection with the examination, to understand the examiner's conclusions and judgments. Therefore, workpapers should not contain any unresolved issues or questions.

Examination Checklists[14]

Examiners should determine the extent to which the applicable examination checklists should be used during each examination or monitoring event. Examiners may elect to use some or all of the checklists and may answer all or only certain checklist questions[15]. In making this determination, examiners should keep in mind that the checklists are an excellent training tool for more inexperienced examiners, and also serve as an aid to more seasoned examiners and review examiners. The checklists can also be a valuable tool when preparing for monitoring events and subsequent examinations.

Checklist questions should be answered in the context of the level of review performed. That is, if no transaction testing is performed, the examiner should answer the checklist questions in the context of a Level I review. For the most part, the checklist questions require "yes" or "no" answers. Generally, a negative response indicates a violative practice; therefore, any "no" answer must be explained in detail in either the checklist or accompanying workpapers. For those areas of the checklist that do not lend themselves to "yes" or "no" answers, narrative responses are required. Any questionable practice noted in the checklist should be fully supported in the workpapers. Reference should be made on the checklist to the appropriate set of workpapers that support relevant findings or conclusions.

Documentation

Workpapers should support the examination findings and should be supplemented with copies of specific bank documents. The need for thorough and accurate completion of the workpapers that document examination findings, including overcharges or allegations of discrimination, cannot be overemphasized.

[14] Checklists for System compliance examinations may be found in this handbook under the applicable tab for the regulation or statute.

[15] The checklists are generic and designed for use in any bank, and examiners may delete those sections of the checklist that do not apply to the particular bank being examined.

APPENDIX I – Consumer Compliance Risk Profile

Updated on [Date]

Prepared by [Name]

CONSUMER COMPLIANCE RISK PROFILE

[State Member Bank (SMB) name, city, state]

RSSD# [Insert]

Institutional Overview

<u>Organizational Structure</u>
Summarize the bank's organizational structure, including comments on the following, as applicable:

- Indicate if the bank is owned by a bank holding company (BHC) or a financial holding company (FHC) and, if so, the BHC's or FHC's degree of operational centralization related to consumer compliance activities
- List those bank subsidiaries with activities that present consumer compliance risk, including those subject to Regulation P
- Discuss any significant structural changes (e.g., mergers, acquisitions, divestitures, consolidations, pending applications) in the bank since the last supervisory event
- Discuss any planned structural changes (e.g., mergers, acquisitions, divestitures, consolidations, pending applications)

<u>Geographic Areas and Markets</u>
Provide a summary that addresses the following (if applicable):

- Geographic markets served by the bank (e.g., states, MSAs, markets served by subsidiaries)
- Number and locations of branches and ATMs
- Indicate if the bank is an interstate bank for Section 109 and CRA purposes and, if so, list the states and Federal Reserve districts in which the bank operates

Business Strategies

Provide a summary of the bank's business strategies, including comments regarding:

- Key business lines
- Product mix
- Marketing emphasis
- Growth areas
- New products
- Delivery channels

Internet Web Site

Provide a brief description of the bank's website (e.g., purpose, types of transactional/inquiry capabilities, future plans) and URL address

Consumer Compliance Supervisory Issues or Concerns

Monitoring Event

Date: [Insert]
Summarize any concerns noted at the most recent monitoring event.

Consumer Compliance Examinations

Date and Rating: [Insert]
Briefly discuss any significant findings at the examination related to the consumer compliance risk management program and any noteworthy compliance violations.
Date of Prior Examination and Rating: [Insert]

CRA Examinations

Date and Rating: [Insert - for large banks show components of CRA rating]
Briefly discuss any significant weaknesses or concerns related to the bank's CRA performance.
Date and Rating of Prior Assessment: [Insert - for large banks show components of CRA rating]

Supervisory Actions

Briefly discuss the status of any supervisory or enforcement actions issued to address consumer compliance-related concerns.

Other Supervisory Issues or Concerns

Briefly discuss any *significant* issues or concerns disclosed at the most recent examinations, as listed below, that may have an impact on the consumer compliance risk management program. Describe any financial conditions that may impair the bank's ability to lend.

Examination	Exam Date	Rating	Agency	Issues or Concerns (if applicable)
Commercial				
BHC				
IT				
Trust				
Transfer Agent				
Municipal Securities Dealer				

Supervisory/Enforcement Actions
List any supervisory or enforcement actions in effect related to these other functions, including the type and date of action, relevant provisions, and current status.

Consumer Complaint Activity
Summarize any relevant complaint issues and trends, particularly those involving fair lending issues.

Litigation
Summarize any significant consumer-related litigation.

Consumer Compliance Risk Management Program

Provide a summary of the bank's consumer compliance risk management program, addressing the following six elements:

- Board of directors and senior management oversight
- Consumer compliance program structure
- Policies and procedures
- Compliance audits/reviews
- Internal controls
- Training

Compliance Risk Management Rating: [Insert]
Provide an assessment of the effectiveness of the bank's consumer compliance risk management processes. The rating should quantify the bank's processes for managing the six elements listed above, by assigning a rating on a scale of 1 through 5, in ascending order of supervisory concern.

Consumer Compliance Risks Applicable to Safety and Soundness

Provide a rating (High, Moderate, or Low) and trend (Increasing, Stable, or Decreasing) for the three areas of risk (Operational, Legal, and Reputational) applicable to safety and soundness.

Risks	Rating	Trend	Comments
Operational			
Legal			
Reputational			

Operational Risk
Provide a brief summary of the factors contributing to the rating and trend. Consider the guidance provided in Appendix VIII.

Legal Risk
Provide a brief summary of the factors contributing to the rating and trend. Consider the guidance provided in Appendix III.

Reputational Risk
Provide a brief summary of the factors contributing to the rating and trend. Consider the guidance provided in Appendix VIII.

Supervisory Plan

Next Examination
Provide the following information:
- Date of next examination. If the recommended date of next examination is earlier than the date prescribed under the frequency schedule, provide an explanation.
- Any supervisory action and planned follow-up (e.g., review of file search or reimbursement results)

Monitoring Event
Provide the following information:
- Date of next monitoring event (i.e., the midpoint between examinations)
- Review of any specialized periodic reporting associated with a supervisory action (e.g., Board Resolution, Memorandum of Understanding, etc.)

Outreach Activity
Comment on the following:
- Planned outreach activities (including dates)

Other Periodic Contacts (optional)
Comment on the following:
- Planned onsite visits, conference calls, or questionnaires/surveys

Appendix II – Consumer Compliance Risk Profile Resource Guidance

INSTITUTIONAL OVERVIEW SECTION

Bank Characteristic	Sources of Information
Organizational Structure	NED (National Examination Data) S&S Examination Report S&S Risk Profile
Geographic Areas or Markets	Prior CRA public evaluation Applications Management and Processing System (AMPS) reports Reserve Bank correspondence file
Business Strategies	S&S Examination Report/Workpapers Board of directors' meeting minutes Interviews Questionnaires Bank strategic plan
Consumer Compliance Supervisory Issues or Concerns	Prior two CA Reports of Examination Enforcement actions Recent monitoring event CARES system AMPs reports
Other Supervisory Issues or Concerns	S&S Examination Report Enforcement actions Reserve Bank watch list NED S&S Risk Profile
Consumer Complaint Activity	CAESAR system Discrimination activity report Consumer complaint summary report
Litigation	S&S Examination Report /Workpapers Board of directors minutes Questionnaires/Interviews

CONSUMER COMPLIANCE RISK MANAGEMENT PROGRAM SECTION

Elements	Sources of Information
Board of Directors and Senior Management Oversight	Board of directors minutes Loan committee minutes Interviews/Questionnaires S&S Report of Examination/Workpapers S&S Risk Profile
Consumer Compliance Program Structure	Previous CA Report of Examination Interviews/Questionnaires Board of directors minutes Compliance committee minutes Organization charts
Policies and Procedures	Board of directors minutes Bank policies/procedures manuals Interviews/Questionnaires S&S Report of Examination/Workpapers
Compliance Audits/Reviews	Internal/External audit reports/compliance reviews and management's responses Audit committee minutes S&S Report of Examination/Workpapers
Internal Controls	Interviews/Questionnaires Policies and procedures manual(s) S&S Examination Report/Workpapers
Training	Bank training records Interviews

APPENDIX III – Guidance for Addressing Safety and Soundness Risks Related to Consumer Compliance Risk

OPERATIONAL RISK

Potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses

LOW	MODERATE	HIGH
Lending and deposit products are relatively noncomplex and no significant changes are anticipated.	Lending and deposit products are moderately complex and no significant changes are anticipated.	Lending and deposit products are highly complex.
No changes in computer operating systems that affect consumer compliance-related functions have occurred since the previous supervisory event or are anticipated prior to the next supervisory event.	Minor changes in computer operating systems that affect consumer compliance-related programs have occurred since the previous supervisory event or are anticipated prior to the next supervisory event.	Significant changes in computer operating systems that affect consumer compliance-related programs have occurred since the previous supervisory event or are anticipated prior to the next supervisory event.
Lending and deposit operations subject to consumer compliance requirements are highly centralized.	Lending and deposit operations subject to consumer compliance requirements are partially centralized.	Lending and deposit operations subject to consumer compliance requirements are decentralized.
Effective internal controls, including consumer compliance-related software, have been in place since the previous supervisory event.	Generally adequate internal controls, including consumer compliance-related software, have been in place since the previous supervisory event but some weaknesses may be present.	The bank's system of internal controls, including consumer compliance-related software, is inadequate.
Effective consumer compliance-related policies and procedures have been in place since the previous supervisory event.	Generally adequate consumer compliance-related policies and procedures have been in place since the previous supervisory event but may need strengthening.	The bank's consumer compliance-related policies and procedures are inadequate.
An effective consumer compliance audit/review program has been in place since the previous supervisory event.	A generally adequate consumer compliance audit/review program has been in place since the previous supervisory event, but weaknesses may be present.	The bank's consumer compliance audit/review program is inadequate.
Consumer compliance staff is appropriately involved in evaluating and implementing new products (including new product distribution channels) or acquisitions of assets and business lines.	Consumer compliance staff is generally involved in evaluating and implementing new products (including new product distribution channels) or acquisitions of assets and business lines, although lead times are not always adequate.	Consumer compliance staff is not adequately involved in evaluating and implementing new products (including new product distribution channels) or acquisitions of assets and business lines, and lead times are inadequate.
Effective board of directors and management oversight of the consumer compliance-related audit/review program, internal controls, and policies and procedures since the previous supervisory event.	Generally adequate board of directors and management oversight of the consumer compliance-related audit/review program, internal controls, and policies and procedures since the previous supervisory event.	Oversight provided by the board of directors and management of consumer compliance-related audit/review program, internal controls, and policies and procedures since the previous supervisory event has been inadequate.
Effective training has been provided to staff regarding consumer compliance regulatory requirements and related policies and procedures since the previous supervisory event.	Generally adequate training has been provided to staff regarding consumer compliance regulatory requirements and related policies and procedures since the previous supervisory event, but may need strengthening.	Training provided to staff regarding consumer compliance regulatory requirements and related policies and procedures since the previous supervisory event has been inadequate.

LEGAL RISK

Potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization		
LOW	**MODERATE**	**HIGH**
Minimal or no pending litigation regarding consumer laws and regulations and no history of significant consumer litigation.	Any pending litigation regarding consumer regulations involves moderate potential legal or financial consequence; limited history of significant consumer litigation.	Pending litigation regarding consumer laws and regulations involves significant potential legal or financial consequence; history of significant consumer litigation.
Effective reviews of policies, procedures, forms, and disclosures for compliance with consumer regulatory and legal requirements.	Generally adequate reviews of policies, procedures, forms, and disclosures for compliance with consumer regulatory and legal requirements, but some weaknesses are present.	Inadequate reviews of policies, procedures, forms and disclosures for compliance with consumer regulatory and legal requirements.
Effective board of directors and management oversight of legal aspects (e.g., significant litigation and consumer complaints, vendor service contracts) of the consumer compliance risk management program.	Generally adequate board of directors and management oversight of legal aspects (e.g., significant litigation and consumer complaints, vendor service contracts) of the consumer compliance risk management program, but some weaknesses are present.	Inadequate board of directors and management oversight of legal aspects (e.g., significant litigation and consumer complaints, vendor service contracts) of the consumer compliance risk management program.
Few, if any, consumer complaints involving issues with minimal potential legal or financial consequences.	Limited number of consumer complaints involving issues with moderate potential legal or financial consequences, or a large number of complaints involving minimal potential legal or financial consequences.	Large number of consumer complaints involving issues with moderate or significant potential legal or financial consequences.
Minimal or no liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts. No civil money penalties (CMPs) assessed (e.g., flood).	Moderate liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts. CMPs, if assessed (e.g., flood), are small.	Significant potential liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts. CMPs assessed (e.g., flood).

REPUTATIONAL RISK

Potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.		
LOW	**MODERATE**	**HIGH**
CRA rating is "Outstanding" or "Satisfactory."	CRA rating is "Satisfactory," but some recommendations for improvement were included in the PE.	CRA rating is "Needs to Improve" or "Substantial Noncompliance."
No formal enforcement actions or public consent agreements in place. No assessments of civil money penalties (CMPs) or referrals to enforcement agencies.	No formal enforcement actions or public consent agreements in place. CMPs, if assessed, are small. No referrals to enforcement agencies of a significant nature.[16]	Formal enforcement actions and/or public consent agreements in place. CMPs are significant. Referrals made to enforcement agencies.
No negative publicity related to compliance with consumer banking laws and regulations.	Little negative publicity related to compliance with consumer banking laws and regulations.	Significant negative publicity related to compliance with consumer banking laws and regulations.
Effective process for handling consumer complaints and few, if any, substantive consumer complaints.	Generally effective process for handling consumer complaints, and a moderate number of substantive consumer complaints.	Ineffective process for handling consumer complaints or a moderate or high number of substantive consumer complaints.
Minimal or no liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts.	Moderate potential liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts.	Significant potential liability under the Policy Statement on the Administrative Enforcement of the Truth in Lending Act and/or the Policy Statement on Enforcement of the Equal Credit Opportunity and Fair Housing Acts.
Business strategy and/or bank products unlikely to raise concern regarding predatory lending and/or unfair and deceptive acts or practices.	Business strategy and/or bank products may raise some concern regarding predatory lending and/or unfair and deceptive acts or practices.	Business strategy and/or bank products likely to raise serious concern regarding predatory lending and/or unfair and deceptive acts or practices.

[16] Technical violations of RESPA that may have been referred to HUD are not considered significant.

Appendix IV - HMDA Sampling Procedures

The following HMDA sampling procedures should be applied when reviewing HMDA-LAR data for accuracy:

1. Identify and select the LAR to be reviewed.

For each HMDA reporter, review both current year and previously submitted HMDA data since the last examination. Every examination conducted after April 30th each year should include a review of the current year's HMDA data. Examinations conducted before April 30th should include a review of the current year's data to the extent that the institution has already entered data from the current year on the LAR. The data from a single year's LAR is the universe from which a sample is taken.

2. Determine the total number of files to be sampled from Column G in Appendix II, based upon the universe size.

3. Select the total random sample.

A. From an Automated Download:

The most important thing to remember is the sample must be randomly selected from the universe. There are a variety of tools an examiner may use to electronically select a random sample of data, including a feature in Excel. The following instructions will assist you in working with Excel:

1. Generate a random order to the universe of records from which the sample will be selected. This generation should be made by utilizing Excel's "Random Number Generation" tool according to the following steps:

   a. Select the following from the Excel menu:

- Tools
- Add-Ins
- Analysis Tool Pak (Check box and click "OK")
- Tools (Again)
- Data Analysis
- Random Number Generation (Highlight and click "OK")

   b. Respond to the items on the Random Number Generation screen as follows:

- Number of Variables (Leave blank)
- Number of Random Numbers (Leave blank)
- Distribution (Select "Uniform" from list)
- Parameters (Leave default as is - it is set at 0 and 1)
- Random Seed (Leave blank)
- Output Options (Click on "Output Range" circle and then click on the small box to the right for "Output Range")

c. A small screen will appear titled "Random Number Generation" but you will not enter any information directly onto that screen. Rather, select the range (output location) for the random numbers by highlighting the column on the spreadsheet where you want the random numbers to go. (Use the "Shift" key and the down arrow to highlight the column.) Hint: Designating a column at the end of the spreadsheet may be easiest.
d. Click on the small box in the "Random Number Generation" screen (or press Enter).
e. Click on "OK".
f. The random numbers are automatically assigned and placed into the designated statistical column.
g. Sort the file in ascending order by the random number by highlighting all of the data, selecting "Data", then selecting "Sort", then identifying the column (containing the random numbers) by which you will sort, then selecting "Ascending", and finally, selecting "OK".

2. Once the loans are placed in a random order, the sample needed for the HMDA verification is simply taken from the top of the list. This information should then be saved as a supporting workpaper.

B. From Hard-Copy LAR:

As with electronic data, a sample of files selected from a manual HMDA report must be randomly selected from the universe.

1. Divide the size of the ‘‘universe’’ by the size of the sample to determine the ‘‘interval.’’ If necessary, round interval down to reach a whole number.
2. Randomly pick a number between zero and the interval.
3. Starting with the beginning of the universe, count the items until the random number is reached. The item that corresponds with the random number will be the first item selected for the sample.
4. Starting with the next consecutive item as number 1, count until the number corresponding with the interval is reached and select that item for the sample.
5. Repeat Step 4. above throughout the entire universe, until the appropriate sample size is reached.

4. Review the initial number of files (Column B in the HMDA Sampling Schedule at the end of this section) utilizing current FRB HMDA data review procedures.

5. The examiner may stop the HMDA sampling process after review of the initial number of files is completed IF the results indicate that a very small number of files had errors in key fields[17]. Using the HMDA Sampling Schedule, this number can be determined by referencing Column C titled "Maximum Number of Files with Errors to Stop Sampling."

For example, if a HMDA universe contains 150 files, a total random sample of 56 files should be taken. The examiner may initially begin file review on 29 files. If, upon completing review of the initial 29 files, the examiner finds no more than one file with any error or errors in key fields, the examiner may end the sampling process for that HMDA reporter for that universe. The examiner may then reach a statistically reliable conclusion that the findings are indicative of the universe and resubmission is not necessary.

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[17]**Key fields** are defined as: loan type, loan purpose, owner occupancy, loan amount, action taken type, MSA, state, county, census tract, applicant race, co-applicant race, applicant sex, co-applicant sex, and income.

6. **The examiner must complete a review of the total random sample of files if a larger number of errors in key fields are found during the initial file review.**

The need for this additional file review can be determined by using Column D titled "Number of Files with Errors - Additional File Review Required" on the HMDA Sampling Schedule. If the number of files with errors in key fields from the initial review falls within the number reflected in this column, the examiner must review the additional files to complete the total random sample.

For example, if a HMDA universe contains 150 files, a total random sample of 56 files should be taken. The examiner may initially begin file review on 29 files. If, upon completing review of the initial 29 files, the examiner finds four files with an error or errors in key fields, the examiner should then review 27 additional files, for a total sample size of 56 files. After completing review of the additional 27 files, the examiner should determine the total number of key field errors and apply the current Board HMDA resubmission standards to the total sample.

7. **If an examiner determines that a large number of files reviewed in the initial file review have an error or errors in key fields, the examiner may stop HMDA data verification after the initial file review is completed and should apply the current Board HMDA resubmission standards.**

This maximum number can be determined by referencing Column E titled "Number of Files with Errors to Stop Sampling - Apply Resubmission Standards on the HMDA Sampling Schedule." For example, if a HMDA universe contains 150 files, a total random sample of 56 files should be taken. The examiner may initially begin file review on 29 files. If, upon completing review of the initial 29 files, the examiner finds six (or more) files with an error or errors in key fields, the examiner should stop file review. Sufficient statistical evidence has been obtained to conclude that a larger sample would have an unacceptable number of errors, thus requiring resubmission. At this point, the examiner should apply the current Board HMDA resubmission standards to the total sample.

Appendix V - HMDA Sampling Schedule

	INITIAL FILE REVIEW					
A **HMDA UNIVERSE**	**B** **Initial File Review**	**C** **Maximum Number of Files with Errors* - Stop Sampling**	**D** **Number of Files with Errors* - Additional File Review Required** **(go to column F)**	**E** **Minimum Number of Files With Errors* - Stop Sampling & Apply Resubmission Standards**	**F** **ADDITIONAL FILE REVIEW**	**G** **TOTAL RANDOM SAMPLE**
1-12	Review all					
12-20	12	0	1	2	Review all	All
21-30	13	0	1	2	Review all	All
31-50	15	0	1-2	3	13	28
51-70	17	0	1-2	3	12	29
71-90	18	0	1-3	4	20	38
91-110	28	1	2-3	4	11	39
111-130	29	1	2-4	5	18	47
131-140	29	1	2-4	5	20	49
141-170	29	1	2-5	6	27	56
171-190	30	1	2-5	6	27	57
191-270	30	1	2-5	6	29	59
271-380	30	1	2-6	7	38	68
381-750	31	1	2-6	7	38	69
751-1100	31	1	2-7	8	48	79
1101-	32	1	2-7	8	47	79

* Files with one or more errors in Key Fields (Key fields identified by the Federal Reserve Board are: loan type, loan purpose, owner occupancy, loan amount, action taken type, MSA, state, county, census tract, applicant race, co-applicant race, applicant sex, co-applicant sex, and income).

Appendix VI - HMDA Resubmission Standards

In order to ensure the integrity of the HMDA data used for analysis, the following guidelines should be used when considering whether to have an institution resubmit HMDA data. The guidelines are broken into two general categories, one for assessing the accuracy of an individual data field, and one for assessing overall accuracy. In addition, the guidelines establish different standards for different fields on the HMDA-LAR depending on the importance of the field for analysis purposes.

Institutions should be required to correct and resubmit a field on the HMDA-LAR when at least 5.0 percent of the LARs sampled was reported incorrectly. The fields, known as the "key fields," covered by this 5.0 percent rule are:

Loan Type
Loan Purpose
Owner Occupancy
Loan Amount
Action Taken Type
MSA
State
County
Census Tract
Applicant Race
Co-Applicant Race
Applicant Sex
Co-Applicant Sex
Income

Rounding errors in the loan amount and income fields should not be counted towards resubmission, although the violations should be cited and the bank should report the data correctly in the future. When the regression program is used on an examination, each of the fields above, except for State, County, Census Tract, Applicant Sex, and Co-Applicant Sex must have less than a 5.0 percent error rate before the step 1 program is run.

Errors in the fields not covered by the 5.0 percent rule - Application Date, Action Date, Type of Purchaser, and Reasons for Denial - should also lead to resubmission if, in the examiner's judgement, these errors prevent an accurate analysis of the institution's lending.

In addition to basing a resubmission on the error rate for an individual field, resubmission could also be required based on the bank's overall rate. If at least 10.0 percent of the institution's records have an error in at least one of the key fields, then the entire HMDA LAR must be resubmitted. In this instance, the institution must verify the data in each of the fields and not just those with greater than a 5.0 percent error rate.

Appendix VI - Monitoring Guidelines

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
MANAGEMENT/STRATEGIC PLAN/ ORGANIZATIONAL STRUCTURE				
1. Has ownership or structure of the bank or its parent changed? How? What other activities are conducted by the BHC?	X	X	X	Examination Reports (safety and soundness, IS, trust, consumer, etc.)
2. Has the bank opened or closed any branches, drive-thru facilities, or ATMs? Is the bank planning to open or close any facilities in the next 12 months?	X	X	X	Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank
3. Has the bank's competitive environment for retail financial services changed significantly? Who are the bank's major competitors?	X			Supervisory Action files
4. Have there been any changes in senior management or compliance related staff? What were the reasons for the change(s)? If new personnel have been added, do these individuals have any background and/or training in compliance matters?	X			Applications NED NIC Board and Committee Minutes (if the bank is willing to copy and send them to the RB)
5. Has there been any change in supervisory actions pending or in place against the bank, the BHC or related entities?	X			
6. Has there been any change in litigation regarding consumer protection laws and regulations pending against the bank?	X	X	X	
7. Has there been any change in how often compliance issues are reported to the board of directors?	X	X	X	
8. Have there been any changes to the compliance policies and procedures? If so, have they been approved by the board?	X	X	X	
9. Has there been a significant increase in loan or deposit volume?	X	X	X	Call Report

[18] Dimensions refer to the categories that are risk rated on the Monitoring Risk Grid (see Monitoring Procedures). MGT = Management, Strategy & Organizational Structure; P&S = Products & Services; FL = Fair Lending

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
10. Which categories have exhibited most growth?	X	X	X	UBPR
11. Has the bank added or eliminated any loan, deposit, or service-related products since the previous examination? 12. Is the bank planning to add or eliminate any loan, deposit, or service-related products within the next 12 months? (For example, providing high cost mortgage loans as described in Section 32 of Regulation Z.)	X X	X X	X X	Call Report (Schedules RC-C, RC-N, RC-E, RC-K) UBPR (Summary Ratios, Yields, Balance Sheet, Off-Balance Sheet Items, Liquidity and Investment Portfolio, Capital Analysis) Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank
13. Has the bank adequately responded to report comments and recommendations?	X	X	X	Correspondence and inquiries from bank
14. Has the bank changed its defined service area since the previous examination?	X		X	Previous Exam Reports
15. Has the bank changed its advertising strategy, including product emphasis and media use?	X	X	X	
INTERNAL CONTROLS				
1. Has responsibility for internal controls/reviews related to compliance matters changed? 2. Have there been any changes in the internal control/review process, including any outsourcing? • Frequency • Comprehensiveness 3. Have there been any changes to the centralization of lending or operations	X X X	 X X	 X X	Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
functions?				
4. Have there been any changes to the automation of lending or operations functions?	X	X	X	
5. Has the bank changed or implemented any new compliance-related software or calculation tools since the previous exam?	X	X	X	Examination Reports (safety and soundness, IS, trust, consumer, etc.)
6. Is the bank planning to change or implement any new compliance-related software or calculation tools within the next 12 months?	X	X	X	Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank
COMPLIANCE AUDITS				
1. Have the members of the bank's audit committee changed?	X			Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank
2. Have any changes been made to who is currently conducting internal compliance audits?	X	X	X	
3. Have any changes been made to how compliance audit findings are reported to the board?	X			
4. Has a new audit/consulting firm been engaged? What compliance experience does the firm have?	X	X	X	
5. Has the audit structure changed? Does management plan to expand, reduce, or hold constant the bank's audit scope or activities?	X	X	X	
6. Has there been any change in the depth or scope of audit for compliance with consumer laws and regulations as well as bank policies and procedures?	X	X	X	
7. Have any recent audits been completed?	X	X	X	
8. Have any audits not been conducted as planned?	X	X	X	
TRAINING				
1. What formal training has been conducted since the previous examination (internal and external)?	X	X	X	Examination Reports (safety and soundness, IS, trust, consumer, etc.)

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
2. Have any changes been made to the training program? 3. How has the bank communicated new or amended regulatory issues?	X X	X X	X X	Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank Reserve Bank Outreach Efforts
PRODUCTS AND SERVICES				
1. Has the bank changed or implemented any new forms or disclosures that affect consumer compliance since the previous exam? 2. Is the bank planning to change or implement any new forms or disclosures that affect consumer compliance within the next 12 months?		X X		Correspondence and inquiries from bank
3. Have any material changes occurred regarding <u>any</u> aspect of the bank's lending operations including: • Number of loan officers? • Changes to the bank's lending policies or underwriting standards? • Purchasing or selling loans on the secondary market? • Changes regarding the use of a particular settlement provider for settlement services? • Has the bank changed any fees or service charges collected in connection with any loan product, including the taking of applications, appraisals, collateral inspection, flood determination, loan origination or commitment and loan documentation since the previous exam? • Is the bank planning to change any fees or service charges collected in connection with any loan product, including the taking of applications, appraisals, collateral inspection, flood determination, loan origination or commitment and loan documentation within the next 12 months?		X	X	Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank HMDA data, if available CRA small business and small farm data (Aggregate Tables) Complaints

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
4. Have any material changes occurred regarding <u>any</u> aspect of the bank's deposit operations including: • Has the bank changed any fees or service charges collected in connection with any deposit product? • Is the bank planning to change any fees or service charges collected in connection with any deposit product?		X		Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank
5. Has the bank implemented a Web site or changed an existing site? • What is the bank's Web site address? • When was the bank's Web site implemented? Please place an "X" by the one following description that applies to the bank's Web site: _____ Used for advertising purposes only (does not include capability to receive e-mail inquiries from current/potential customers) _____ Used for advertising and e-mail inquiries from current/potential customers _____ Used for advertising and to conduct transactional/inquiry activities with customers (also may or may not include e-mail inquiry capabilities). If the bank offers transactional/inquiry activities on its Web site, please place an "X" by all those transactions that are offered: _____ Account inquiry _____ Transfer funds between deposit accounts _____ Open deposit account _____ Bill payment services _____ Bill presentment services _____ Loan and/or credit card applications _____ Make loan payments (via	X	X	X	Internet Examination Reports (safety and soundness, IS, trust, consumer, etc.) Interim Monitoring (safety and soundness, IS, trust, consumer, etc.) Correspondence and inquiries from bank

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
transfer) _____ Investment transactions _____ Corporate/business services _____ Other transactions. 6. Does the bank have any future plans for a Web site or plans for enhancing the existing website?	X	X	X	
FAIR LENDING[19]				
1. Are there any Community Contacts or consumer complaints alleging discrimination?			X	Community Contacts: • Previous exam • Interagency from other financial institutions in market • Follow-up interviews Consumer Complaints since previous exam (CAESAR) Complaints at non-banking subs
2. What is the loan activity for the last 12 months, by product?		X	X	HMDA LAR (for reporters)
3. Can the bank provide an estimate of the number or percentage of denials for the previous twelve months by product type? For example, specific number of denials for real estate loans, auto loans, home equity lines of credit, commercial loans, etc.		X	X	HMDA LAR (for reporters)
4. Is there evidence of potential disparities in lending or other risk factors?			X	Previous exam maps or gap analyses identify products that should be evaluated/subject to follow-up Step I – Matched Pair report FLAG Summary Package HMDA Data (Institution and Aggregate Tables) CRA Small Business & Small Farm Data (Aggregate Tables)
5. Have the procedures that the institution adopted to ensure equal opportunity to credit and			X	Previous Exam Workpapers

[19] An onsite supervisory visit will be required for all banks that have not yet been examined using the interagency fair lending examination procedures, all banks for which the offsite review of data indicates a deterioration in the bank's fair lending compliance posture, and for banks that do not report HMDA data, unless the Reserve Bank is able to obtain detailed loan data to facilitate an offsite review.

	DIMENSIONS[18]			SOURCES
OBJECTIVE/QUESTION	**MGT**	**P&S**	**FL**	**INFORMATION MONITORING**
compliance with fair lending laws and regulations changed?				Commercial Exam Report Internal Supervisory Databases Correspondence File
6. Has the bank added or changed its relationships with loan brokers, automobile dealers, or appraisers?		X	X	Previous Exam Report and/or Workpapers Commercial Examination Report

Appendix VIII - Monitoring Risk Grid

	RISK			TREND					
DIMENSIONS	**Low**	**Mod**	**High**	**Decreasing**	**Stable**	**Increasing**	**Super-visory Visit**	**Exam-ination**	**No Further Action**
Management, Strategy & Organizational Structure									
Products & Services									
Fair Lending									
Resulting Activity									
Comments:									