Board of Governors of the Federal Reserve System

REPORT ON THE FAILURE OF THE BANK OF EPHRAIM

OFFICE OF INSPECTOR GENERAL

August 2005

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

August 30, 2005

The Honorable Susan S. Bies
Chairperson
Committee on Supervisory and Regulatory Affairs
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Governor Bies:

The Office of the Inspector General of the Board of Governors of the Federal Reserve System (Board) is pleased to present its *Report on the Failure of the Bank of Ephraim*. The Bank of Ephraim (BOE), a small community bank founded in 1905, had offices in central and southern Utah serving residents, businesses, and other institutions until it was closed on June 25, 2004. BOE, a state chartered member bank of the Federal Reserve System, was supervised by the Federal Reserve Bank of San Francisco (FRB San Francisco) under delegated authority from the Board. The objectives of our review were to ascertain why the institution's problems resulted in a loss to the Bank Insurance Fund, and make recommendations, if warranted, for preventing any such loss in the future.

BOE failed because the institution's cashier exploited a weak corporate governance environment and inadequate internal control structure to embezzle funds and conceal the fraud by systematically manipulating the bank's financial records. Simultaneously, problems with the bank's loan portfolio were eroding available capital and, when the fraud was discovered, the bank was deemed undercapitalized and subsequently declared insolvent. We found that while Reports of Examination and examiner work papers consistently identified internal control weaknesses that often pointed to the cashier, FRB San Francisco did not compel bank management to take corrective action. In addition, FRB San Francisco examination managers did not recognize the inherent risks posed by the recurrent nature of internal control deficiencies, and did not adjust the scope of subsequent examinations in accordance with risk-focused examination principles.

In our opinion, these longstanding and repeated weaknesses should have led to more in-depth testing which would have increased the likelihood that the fraud could have been uncovered earlier. We also found that FRB San Francisco examination managers did not fully recognize the cumulative magnitude of recurrent credit and loan administration weaknesses consistently identified by examiners. In our view, the timing, intensity, and scope of the informal supervisory actions taken were not commensurate with these risks. Accordingly, the bank continued its poor lending practices, which resulted in a high volume of inherently risky loans in the bank's southern Utah branch.

FRB San Francisco conducted a quality assurance review of BOE's supervision shortly after the bank was closed, and identified a number of factors that may have contributed to the Reserve Bank's failure to recognize the pattern of BOE's weaknesses. These factors included a lack of continuity in the management of BOE's supervision and significant staff turnover. FRB San Francisco has responded to the quality assurance review and other external assessments with a number of internal initiatives to strengthen examination planning, evaluations of internal controls, and the tools examination managers use to follow up on previous findings. We believe that these initiatives will help address many of the factors that contributed to lapses in BOE's supervision. We did not identify any deficiencies in the Federal Reserve's supervisory guidance and procedures; therefore, we are not making any formal recommendations.

Appendix 2 contains the Director of the Division of Banking Supervision and Regulation's response to a draft copy of this report. The Director welcomed our report's contribution to understanding the failure of BOE, and highlighted the crucial importance of effective examination management and adherence to fundamental principles of risk-focused supervision. He noted that the Division plans to monitor the progress of FRB San Francisco initiatives that respond to the issues raised by our report. The Director said that our report will be distributed to senior officers in charge of supervision at all of the Reserve Banks for dissemination to examination and supervision management and staff. It also will be discussed with System supervision management groups and in examiner forums, and will be sent to the Staff Development Subcommittee of the Strategic Plan Steering Committee to determine if any changes or adjustments are warranted in the System's training programs.

We have provided copies of this report to Board officials and it will be added to our publicly-available web site at www.federalreserve.gov/oig. We will also include a summary of the report in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,

/signed/

Barry R. Snyder
Inspector General

cc: Vice Chairman Roger W. Ferguson, Jr.
Governor Mark W. Olson

Board of Governors of the Federal Reserve System

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BACKGROUND

The Bank of Ephraim (BOE), founded in 1905, was a small, state chartered member bank of the Federal Reserve System, owned primarily by its board members and others within the local community. BOE offered services to residents, businesses, and other institutions through three offices in central Utah and one in southern Utah. The Commissioner of the Utah Department of Financial Institutions (State of Utah) closed BOE on June 25, 2004, after a $4.97 million charge-off—attributed to an embezzlement by the bank's cashier, Randy K. McArthur (McArthur)—rendered the bank insolvent. It is important to note that several years prior to BOE's closure, ongoing asset quality problems had already affected its capital position. BOE had total assets of approximately $46.4 million, with $4.3 million in capital prior to the charge-off.

In September 2004, McArthur and an outside accomplice who helped perpetrate the fraud, pleaded guilty to violating Title 18, United States Code Section, 1344, "Bank Fraud," and were sentenced in the United States District Court, District of Utah, in March 2005. McArthur and his collaborator received prison terms of seven years, three months, and three years, five months, respectively. In addition, they were ordered to jointly pay $2 million in restitution to the Federal Deposit Insurance Corporation (FDIC), with McArthur being responsible for reimbursing an additional $1 million.

As of June 2005, the FDIC estimated that BOE's failure would result in a $4.7 million loss to the Bank Insurance Fund (BIF). Section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the Inspector General of the appropriate federal banking agency review the agency's supervision of a failed institution if the loss to the BIF is considered material.[1] Although the loss associated with BOE's failure was not material under the provisions of the FDI Act, we performed this review because the failure involved fraud and, in our view, the projected loss, totaling ten percent of the institution's assets, was relatively high.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to (1) ascertain why the institution's problems resulted in a loss to the BIF, and (2) make recommendations for preventing any such loss in the future. To accomplish these objectives, we interviewed staff from the Board of Governors of the Federal Reserve System (Board), the Federal Reserve Bank of San Francisco (FRB San Francisco), the State of Utah, the FDIC's Division of Resolutions and Receiverships (DRR), and the Federal Bureau of Investigation (FBI). We reviewed supervisory records that included surveillance reports, Reports of Examination issued between 1994 and 2004, examination work papers retained by FRB San Francisco, e-mails, and other correspondence. We also reviewed FRB San Francisco's post-failure, internal quality assurance report of BOE's supervision, and other external evaluations of FRB San Francisco's supervision function. In addition, we reviewed DRR's documents and reports related to the failure, BOE's external auditor's work papers, and

[1] The FDI Act considers a loss material if it exceeds the greater of $25 million or two percent of the institution's total assets.

the results of forensic accounting work related to the fraud. Our review was conducted in accordance with generally accepted government auditing standards.

FRAUD CAUSED THE BANK OF EPHRAIM TO FAIL

BOE failed because of losses associated with an embezzlement committed by the bank's cashier. Our analysis revealed that McArthur operated in an environment with improper segregation of duties and inadequate managerial oversight. He had a broad range of authorities that included initiating and recording financial transactions, handling cash and official checks, and reconciling general ledger accounts. As such, McArthur was able to exploit BOE's weak internal control environment to perpetrate the fraud and systematically alter the bank's financial records to conceal his illegal activities.

In April 2004, an anonymous caller informed bank management and local law enforcement authorities that McArthur was involved in a longstanding embezzlement scheme. In response, the bank conducted an internal investigation and discovered a significant discrepancy in the accounts for which McArthur prepared monthly reconciliations. During a May 11, 2004 interview with the FBI, McArthur confessed to embezzling approximately $5 million over a 20-year period.

Our analysis of work performed by accountants hired by BOE to quantify the defalcation, and insights gained from discussions with DRR staff, provided an overview of the fraud. Primarily, McArthur embezzled money by preparing and authorizing BOE's cashier's checks drawn on BOE's correspondent bank account, then cashing the checks at a local bank under the pretense of replenishing cash in BOE's vault when, in fact, he kept the money. [2] On average, McArthur cashed ten to twelve checks per year, each ranging from $11,000 to $30,000. Because McArthur kept the money, he made no entries showing that the proceeds from cashier's checks were deposited into BOE, and ultimately reflected on BOE's general ledger. As a result, the correspondent bank account balance, as reported on account statements regularly mailed to BOE, did not agree with the correspondent bank balance on BOE's general ledger.

To conceal this difference, McArthur intercepted correspondent bank account statements and, with assistance from his outside accomplice, altered and replaced the originals along with selected pages of BOE's general ledger. Using these altered documents, McArthur prepared fraudulent reconciliations that showed a falsely inflated correspondent account balance that contained imaginary transactions included as part of "in process" items to be collected or paid in the future. McArthur then altered additional account statements and ledger pages to show that these transactions were subsequently collected or paid, making it appear that the account balance reported on the bank statement was in agreement with the general ledger balance.

[2] A correspondent bank holds deposits owned by other banks and performs banking services such as check clearing. Larger, more complex financial institutions tend to act in this capacity for smaller banks.

SUPERVISION OF THE BANK OF EPHRAIM

The Federal Reserve System uses a risk-focused approach when planning and conducting bank safety and soundness examinations. This approach calls for Reserve Banks to continuously assess institutions under their purview and tailor examinations based on each bank's risk profile. A key premise of risk-focused supervision entails performing in-depth testing when an institution's risk management processes or internal controls are considered weak.

FRB San Francisco's regional and community bank supervision and regulation function includes two officers—Directors of Financial Exams—who report to the Vice President/Managing Director, and are responsible for safety and soundness examinations. These officers in turn oversee Central Points of Contact (CPCs) and Team Leaders. CPCs monitor a group or portfolio of state member banks, and are responsible for preparing risk assessments, supervisory strategies and examination plans. They also coordinate supervisory activities with state and other federal bank regulators. Team Leaders are responsible for supervising and providing guidance to an assigned group of examiners, and work closely with CPCs.

Supervisory History and Analysis

FRB San Francisco and the State of Utah conducted thirteen examinations between 1994 and 2004 (see Table 1). These examinations were performed jointly with the regulators periodically alternating in the lead role. As shown in the table, BOE was considered a fundamentally sound bank and continued to receive CAMELS composite ratings of 1 or 2 through the 1999 examination. Examiners lowered BOE's composite to 3 in 2000 due to concerns regarding asset quality, then upgraded the bank to a composite 2 in 2001, noting that the bank's new management team was actively addressing prior examination findings. However, in 2002 examiners lowered the composite back to 3 in part because of concerns over the bank's asset quality. For the final two examinations, examiners reported continued deterioration in the bank's condition, and lowered the composite rating to 4 in 2003, and 5 in 2004. In addition, from 2000 to 2004, FRB San Francisco issued three informal and two formal supervisory actions.[3] In the weeks preceding the closure, FRB San Francisco issued two Prompt Corrective Action letters downgrading the bank's capital position.[4]

[3] Informal supervisory actions are designed to address supervisory concerns, while formal supervisory actions are legally binding, and are imposed on banks that require stronger, immediate corrective action.

[4] Prompt Corrective Action, a requirement under the FDI Act, requires regulators to administer timely corrective action to banks when their capital condition declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice.

Table 1. Examination History

As of Date	CAMELS Composite Rating [a]
06/30/1994	2
06/30/1995	2
03/31/1996	1
06/30/1997	1
09/30/1998	2
12/31/1999	2
09/30/2000 [b]	3
12/31/2000	3
09/30/2001 [b]	No rating given [c]
12/31/2001	2
12/31/2002	3
09/30/2003 [d]	4
03/31/2004	5

a. Refer to Appendix 1 for definition of CAMELS Composite ratings
b. Targeted examination
c. Examination limited to evaluating Bank Secrecy Act compliance
d. Limited scope examination

Our analysis showed that FRB San Francisco examiners consistently surfaced weaknesses in BOE's internal control structure and credit and loan administration. Nevertheless, examination managers did not translate these deficiencies into an expanded examination scope that included detailed internal control testing. Moreover, FRB San Francisco did not impose timely, formal supervisory actions requiring BOE to strengthen its lending practices and augment its deteriorating capital position.

With respect to internal controls, examiners cited inadequacies in the bank's process to ensure the integrity of account reconciliations in seven of the ten full scope examinations in the decade preceding the bank's failure. Moreover, examination work papers revealed even more explicit concerns regarding the bank's internal control weaknesses that often pointed specifically to McArthur. For example, during the 1998 examination, an examiner documented a discussion during which McArthur admitted that he no longer knew how to reconcile the correspondent bank account, and had not done so for two months, because of changes in how funds were automatically transferred between BOE accounts. The work papers also noted that an account reconciliation prepared by McArthur was not appropriately supported by documentation. Similarly, the 2001 examination work papers cited weaknesses in the quality of reconciliations due to the, "Cashier's lack of training or understanding of the necessity for good numbers." These work papers documented examiners' concern that McArthur was a "…weak link in the management team," and noted that he delayed providing examiners with reliable financial data.

Despite recurrent questions regarding McArthur's ability to perform his duties and reports of consistent weaknesses in the account reconciliation process, the objectives of subsequent examinations were not modified to sufficiently address risks posed by these chronic deficiencies. According to guidance on the risk-focused approach in the *Commercial Bank Examination Manual*, additional transaction testing is warranted and should be included in the scope of examination when internal controls are considered inappropriate. In our view, the longstanding and repeated account reconciliation weaknesses should have led examination management to require more in-depth testing including an independent verification of reconciliations prepared by McArthur. Independent testing would have increased the likelihood for discovering the fraud earlier.

Similar to the situation with internal controls, Reports of Examination repeatedly identified recurring problems with credit and loan administration. When viewed collectively, these longstanding and recurrent weaknesses point to BOE's inability to identify and manage risks in its loan portfolio. As shown in Table 2 below, some of the weaknesses frequently cited included insufficient loan documentation, improper loan extensions and renewals, the lack of a loan grading system, and problems with management's assessments of underlying collateral.

Table 2. Recurrent Credit and Loan Administration Weaknesses

Credit and Loan Administration Weaknesses	1996	1997	1998	1999	2000[5]	2001	2002	2003	2004
Loan Documentation Exceptions	✕	✕	✕	✕	✕	✕	✕	✕	✕
Past Due & Non Accruals concerns	✕	**	✕	✕	✕	✕	✕	✕	✕
Unreliable collateral assessment		✕	✕	✕	✕	**	✕	✕	✕
Loan Grading System Deficiencies			✕	✕	✕	✕	**	✕	✕
Improper Loan Extensions			✕	✕	✕	✕	***	***	***
Loan concentration in southern Utah branch (opened in 1995)*			✕	✕	✕	✕	✕	✕	✕

*While the concentrations began decreasing after 2001, Reports of Examination continued to cite this problem as posing a significant risk.
**Although not specifically mentioned during this examination, this weakness subsequently resurfaced.
***While the practice of improper loan extensions ceased, the financial impact continued to be realized.

Notwithstanding these recurring deficiencies, FRB San Francisco did not take timely supervisory actions to ensure that BOE's management addressed and resolved these problems. Consequently, the bank continued its poor lending practices which resulted in inherently risky loans, particularly in the southern Utah branch. Indeed, the 1998 and 1999 Reports of Examination stated that a majority of the bank's problem loans originated from the southern

[5] These results were derived from two examinations during 2000.

Utah branch. By September 2000, this branch accounted for 50 percent of BOE's loan portfolio and 95 percent of the bank's problem loans.

FRB San Francisco did not impose a supervisory action until late 2001 and, even then, the measure taken was informal, although it focused on limiting the concentration of certain collateral-based lending prevalent in the southern Utah branch. A Report of Examination issued in April 2003 emphasized that the bank needed to raise additional capital to support the high volume of impaired assets, and to maintain capital at a level commensurate with the bank's risk profile. Subsequently, another informal supervisory action was issued directing the bank to raise capital, submit a written portfolio-wide strategy to prevent further asset quality deterioration, and reduce exposure to the southern Utah branch's portfolio. By May 2004, FRB San Francisco determined that BOE's efforts to address these informal provisions were unsatisfactory, and a formal enforcement action was issued. BOE's progress towards satisfying the enforcement action requirements could not be determined because the bank failed one month later due to the fraud.

FRB SAN FRANCISCO INITIATIVES SUBSEQUENT TO THE FAILURE

FRB San Francisco initiated a quality assurance review in response to the BOE failure that provides insight into why examination managers did not translate repeatedly identified internal control and credit and loan administration deficiencies into an examination scope that included detailed testing, and earlier, formal supervisory actions. According to this review, there was an overall lack of continuity in the management of BOE's supervision. Between 1998 and 2003, managerial responsibility for BOE's supervision was transferred four times between three locations within the Reserve Bank district. During this period, BOE was monitored by six different CPCs, and examiners were managed by four different officers. Concurrently, FRB San Francisco was experiencing significant staffing challenges attributed to unusually high attrition caused by the Year 2000 conversion and the "Internet bubble."[6] While these factors may be valid explanations for the lapses in BOE's supervision, in our opinion, the potential risks posed by these issues should have been addressed by FRB San Francisco management in a timelier manner.

A variety of initiatives designed to enhance regional and community bank supervision were either already underway prior to the BOE failure, or planned in response to the weaknesses identified in the quality assurance review and other external assessments conducted by the Board. Some of the more salient efforts include:

- Clarifying roles and responsibilities of CPCs and Team Leaders to improve communication, facilitate transfer of knowledge, and track the resolution of outstanding exam issues, particularly, when institutions are handed-off between managers.

[6] The term "Internet bubble" refers to a period of rising stock prices led by high-tech companies oriented to the Internet.

- Directing examination supervisors to take a minimum three-year look back when scoping examinations.

- Developing a database to capture trends in key supervisory issues that arise during financial and compliance examinations.

- Conducting enhanced offsite pre-examination financial analysis.

- Modifying examination work programs to ensure that internal controls, including account confirmation and reconciliation processes, are consistently and thoroughly reviewed.

- Forming a supervision committee to oversee problem banks and deal with emerging issues.

We believe that these initiatives will help address many of the factors that contributed to lapses in BOE's supervision. Moreover, we did not identify any deficiencies in the Federal Reserve's supervisory guidance and procedures; therefore, we are not making any formal recommendations.

ANALYSIS OF COMMENTS

We provided a draft copy of this report to the Director of Banking Supervision and Regulation for his review and comments. In his response (see Appendix 2), the Director noted that his Division plans to monitor the progress and effectiveness of FRB San Francisco's initiatives that respond to the issues raised by our report and other external reviews. The initiatives include assuring continuity of supervision and management oversight when responsibility for an institution is transferred within the Reserve Bank; and bolstering examination planning, internal control evaluations; and the tools examination managers use to follow up on previous findings. The Director noted that the BOE case accentuates the importance of effective district management oversight in establishing the appropriate scope of individual examinations, assessing the validity of examiner findings, and assuring the appropriate and timely supervisory follow up of key issues. He also acknowledged our report's emphasis on the importance of a critical risk focused supervision principle: the need to escalate the scope and depth of reviews when important issues are identified.

The Director said that our report will be distributed to the senior officers in charge of supervision at all of the Reserve Banks for dissemination to examination and supervision management and staff. In addition, he noted that the report will be discussed with System supervision management groups and in examiner forums, and will be sent to the Staff Development Subcommittee of the Strategic Plan Steering Committee to determine if any changes or adjustments are warranted in the System's training programs. The Director concluded his comments by welcoming our report's contribution to understanding the BOE failure, and highlighting the crucial importance of effective examination management and adherence to fundamental principles of risk-focused supervision.

APPENDIXES

APPENDIX 1 – CAMELS RATING SYSTEM

On December 20, 1996, the Board adopted a revised Uniform Financial Institutions Rating System that was originally adopted by the Board in 1979. Over the years, this system has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern. The rating framework also assists the public and Congress in assessing the aggregate strength and soundness of the financial industry.

Under the current supervisory guidance, each institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk (CAMELS). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a 5 indicates the lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

COMPOSITE RATING DEFINITION

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

Composite 1

Financial institutions in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management.

Composite 2

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

APPENDIX 1 – CAMELS RATING SYSTEM (cont'd)

Composite 3

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

Composite 4

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

Composite 5

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

APPENDIX 2 – DIVISION DIRECTOR'S COMMENTS

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date: July 27, 2005

To: Barry R. Snyder, Inspector General

From: Rich Spillenkothen, Director, Division of Banking Supervision and Regulation RSh/Sn 4.17.

Subject: Draft *Report on the Failure of the Bank of Ephraim*

The staff of the Division of Banking Supervision and Regulation has reviewed the draft Report on the Failure of the Bank of Ephraim (BOE) prepared by the Office of the Inspector General (IG). Although the loss associated with BOE's failure was not material under the provisions of the Federal Deposit Insurance Act, the OIG conducted the review because the failure involved fraud, and because the Federal Deposit Insurance Corporation's initial estimate of loss was relatively high in relation to the bank's assets.

The IG report does not identify any deficiencies in the Federal Reserve's supervisory guidance and procedures, but does identify weaknesses in oversight of the examination process by management of the Federal Reserve Bank of San Francisco. As noted in your report, the Reserve Bank has taken a number of steps to identify the factors that contributed to the weaknesses in supervision oversight noted in the report, and has responded to these findings and other observations with a number of initiatives designed to substantially strengthen examination planning, evaluations of internal controls, and the tools examination managers use to follow up on previous findings. In addition, the Reserve Bank has implemented measures to facilitate the transfer of knowledge and assure continuity of supervision when management oversight of an institution is transferred. This Division will continue to monitor the progress and effectiveness of these initiatives.

The BOE case highlights the importance of effective district management oversight in establishing the appropriate scope of individual examinations, in assessing the validity of examiner findings, and in assuring the appropriate and timely supervisory follow-up of key issues. Additionally, the report emphasizes the importance of a critical risk-focused supervision principle: the need to escalate the scope and depth of reviews when important issues are identified. The final IG report will be distributed to the senior officers in charge of supervision at all of the Reserve Banks for dissemination to examination and supervision management and staff. In addition, the report will be discussed with System supervision management groups and in examiner forums, and will be sent to the Staff Development Subcommittee of the Strategic Plan Steering Committee to determine if any changes or adjustments are warranted in the System's training programs.

This Division appreciates the opportunity to comment on the IG report and welcomes the report's contribution to understanding the failure of BOE and the crucial importance of effective management of the examination process and adherence to fundamental principles of risk-focused supervision.

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cc: Terry Schwakopf
Executive Vice President
Federal Reserve Bank of San Francisco

APPENDIX 3 – PRINCIPAL CONTRIBUTORS TO THIS REPORT

Kyle R. Brown, Project Leader, Senior Auditor

Ariane Ford, Auditor

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