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# Preface

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The bank examination process is the Federal Reserve's fact-finding arm in discharging its regulatory and supervisory responsibilities. The essential objectives of an examination are (1) to provide an objective evaluation of a bank's soundness and compliance with banking laws and regulations, (2) to permit the Federal Reserve to appraise the quality of management and directors, and (3) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, rulings, and regulations.

To accomplish these objectives, the examiner should evaluate the prudence of the bank's practices, the bank's adherence to laws and regulations, the adequacy of the bank's liquidity and capital, the quality of the bank's assets and earnings, the nature of the bank's operations, and the adequacy of the bank's internal control and internal audit. The scope of an examination may cover every phase of banking activity, or it may concentrate on specific areas that deserve greater emphasis because of their potential effect on a bank's soundness.

## ABOUT THIS MANUAL

The goal of the *Commercial Bank Examination Manual* is to organize and formalize longstanding examination objectives and procedures that provide guidance to the examiner, and to enhance the quality and consistent application of examination procedures. The manual provides specific guidelines for—

- determining the scope of an examination;
- determining the procedures to be used in examining all areas of a bank, including those procedures that may lead to the early detection of trends that, if continued, might result in a deterioration in the condition of a bank;
- evaluating the adequacy of the bank's written policies and procedures, the degree of compliance with them, and the adequacy of its internal controls;
- evaluating the work performed by internal and external auditors;
- evaluating the performance and activities of management and the board of directors;

- preparing workpapers that support examination reports and aid in evaluating the work performed; and
- using objective criteria as a basis for the overall conclusion, and for the resulting comments and criticism, regarding the condition and quality of the bank and its management.

The examiner-in-charge must properly plan and organize the examination before work begins. Initial decisions concerning examination scope can usually be made based on the nature of the bank's operations; its size; the past experience of the examiner-in-charge with the bank; information in the previous examination report, including the condition of the bank at that examination; communications with the bank between examinations; and analysis from the Uniform Bank Performance Report. The planning of work and preexamination procedures are covered in the Examination Planning section of this manual.

Examiners should view the manual as a working tool rather than as a reference manual. In most sections of the manual, examination procedures and internal control questionnaires are provided to form the basis for the examination of a bank. These procedures should lead to consistent and objective examinations of varying scopes. The bank's condition is disclosed by the performance of examination procedures, including review of internal controls and audit function, and the evaluation of the results therefrom, not by the examiner's judgment alone.

For larger banks, additional examination procedures need to be incorporated into the process to effectively examine those institutions' complex organizational reporting and accounting systems. Conversely, some of the procedures contained in this manual do not apply to smaller-sized banks. Additionally, state laws and local characteristics necessitate supplemental procedures. For example, specific procedures relating to various types of agricultural lending have not been developed in this manual. Similarly, state banking laws must be considered when applying the procedures to various areas, such as lending, capital adequacy, and pledging requirements. When modifying the procedures, the examiner-in-charge is responsible for determining that the examination objectives are met and that the examination meets the needs of the individual bank.

The manual is also intended to guide examiners in their efforts to encourage banks to develop written policies and related procedures in all areas where none exist, and to correct situations where there are deficiencies in or a lack of compliance with existing procedures. To aid the examiner, this manual includes topics such as loan portfolio management, investment portfolio management, asset and liability management, earnings analysis, capital analysis, and service area analysis. A section on the appraisal of bank management guides the examiner in assembling and evaluating information from all other manual sections and helps uncover inconsistencies in the application of bank policies among various management groups. Examiners should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow the best practices that currently exist in the banking industry. In no case, however, should this approach discourage the development and implementation of conceptually sound and innovative practices by individual banks.

Although this manual is designed to provide guidance to the examiner in planning and conducting bank examinations, it should not be considered a legal reference. Questions concerning the applicability of and compliance with federal laws and regulations should be referred to appropriate legal counsel. In addition, the manual should not be viewed as a comprehensive training guide. Separate training programs provide more detailed instructions to assist the examiner in better understanding banking operations and applying examination procedures.

## HOW TO USE THIS MANUAL

### Organization

The *Commercial Bank Examination Manual* is divided into nine major parts, each set off by a divider tab:

- Part 1000—Examination Planning
- Part 2000—Assets
- Part 3000—Liabilities and Capital
- Part 4000—Other Examination Areas
- Part 5000—Assessment of the Bank
- Part 6000—Federal Reserve Examinations
- Part 7000—International
- Part 8000—Statutes and Regulations
- Appendix

Sections in each part are made up of four subsections, where applicable. They are—

- an overview
- examination objectives
- examination procedures
- internal control questionnaire

The overviews, for the most part, summarize the respective topics. This information is expanded on and reinforced through the Federal Reserve's educational programs and the examiner's experience on the job.

The examination objectives describe the goals that should be of primary interest to the examiner. Two of the objectives determine the scope of the examination for the specific area of examination interest. They are (1) the evaluation of the system of internal control and of bank policies, practices, and procedures, and (2) the evaluation of the scope and adequacy of the audit function. Other common objectives are to determine compliance with laws, regulations, and rulings, and to determine the need for corrective action.

The examination procedures include procedures to be performed during a full-scope, comprehensive examination. In some instances not all of the procedures apply to all banks; examiners may exercise some flexibility depending on the particular characteristics of the bank under examination. The materiality and significance of a given area of bank operations are the examiner's primary considerations in deciding the scope of the examination and the procedures to be performed. Examiner flexibility results in examinations tailored to fit the operations of the bank.

The evaluation of a bank's internal control environment should encompass a review of the internal audit activities and the implementation of selected internal control questionnaires (ICQs), which set forth standards for operational control. Due to the difference between an examination and an audit, it is not contemplated that all ICQs will be implemented in any one examination. The body of ICQs used during the course of the examination should be made up of three elements: (1) those mandated for all examinations, (2) those selected by the examiner-in-charge based upon experience, knowledge of problems within the bank, and perception of risk, and (3) those that focus on areas where on-site evaluation of operational control appears warranted in light of the results of the examina-

tion of internal audit activities. In addition to serving as a guide during on-site evaluations, the ICQs can be used in the appraisal of operational audit techniques in banks where the scope of internal auditing includes such considerations. The ICQ steps marked with an asterisk require substantiation by observation or testing; they are considered to be fundamental to any control program regardless of the size of the institution. These steps should be incorporated in management control programs in smaller banks to compensate for the absence of internal auditing.

Following the main parts are a listing of statutes and regulations administered by the Federal Reserve and an appendix that includes various forms, checklists, statements, and guidelines, which provide the examiner with additional information regarding certain topics.

## Numbering System

The manual is arranged using a numbering system based on the manual's sections and subsections. For example, the overview subsection of the Internal Control section is numbered 1010.1. 1010 is the section number for Internal Control, and .1 is the number for the overview. The examination objectives subsection for that section is numbered 1010.2, and so on. Subsections are always numbered consecutively regard-

less of the number of subsections within a particular section.

The appendix sections begin with the letter A, followed by the number of the section to which the item relates. For example, the Supplement on Internal Auditing for the Internal Control section is numbered A.1010.1. Should the Internal Control section have more than one appendix item, the numbering would appear as A.1010.1, A.1010.2, etc.

## Updates

Beginning with the March 1994 reprint of the *Commercial Bank Examination Manual*, all manual pages are dated March 1994. Succeeding updates will be dated the month and year in which they are issued. There is an effective date at the top of the first page of each subsection that shows the last time that subsection was updated.

The manual is usually updated in the spring and fall of each year; special supplements are issued as needed. On the back of the title page is a checklist so you can record when an update has been filed. For this manual to be most useful, it is essential that updated pages be filed as soon as possible. If you have any questions about receiving updates, please contact Publications Services, Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, D.C. 20551; 202-452-3244.