## THE CHANGING SUPERVISORY EXAMINATION PROCESS, SIGNIFICANT LAWS, REGULATIONS, SUPERVISORY POLICY AND GUIDANCE

In response to new bank legislation and the changing regulatory environment, the examination process has continually evolved to meet a variety of challenges. To understand what challenges and responsibilities examiners may encounter over time, it is necessary to understand (1) what the changes have been, (2) how or when they occurred, and (3) what actions the supervisory agencies have taken to mitigate and control institutions' risk exposures while safeguarding the safety and soundness of banks and the banking system as a whole. To assist with that understanding, a chronological summary of significant legislative, regulatory, and supervisory policies is provided below. These actions, beginning with the late 1980s, have contributed to the current banking environment and the challenges posed to examiners on an ongoing basis.

## 1987

Specific time limits were established for various types of deposits by the Competitive Equality Banking Act. Funds deposited into an account of a depository institution using local and in-state checks are required to be made available the next business day. Funds deposited with all other checks are to be available on the fourth business day after deposit.

## 1989

The federal depository institution supervisory agencies' enforcement powers over the institutions they supervise were expanded by the Financial Institutions Reform and Recovery Act. The legislation included the power to disapprove the appointment of directors and senior officers of certain depository institutions and depository institution holding companies.

## 1991

Supervisory reforms were implemented. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) prohibited insured depository institutions that are not well-capitalized from accepting funds through a deposit broker. Annual on-site examinations and fiscal status reports for all insured depository institutions were required. The annual examination requirement was later revised by the Riegle Community Development and Improvement Act of 1994, which raised the examination frequency to 18 months for smaller banking institutions. These smaller banking institutions were later defined as having less than $250 million in assets by the Economic Growth and Regulatory Paperwork Reduction Act of 1996. This asset threshold level was further raised to less than $500 million by the Financial Services Regulatory Relief Act of 2006, subject to certain specific criteria.

FDICIA was enacted, in part, as a less costly resolution for insured banks and to improve their supervision and examination. It required the federal banking agencies to prescribe standards for credit underwriting, loan documentation, and other policies to preserve the safety and soundness of banks. FDICIA established the prompt corrective action (PCA) standards for undercapitalized banks. Based on their level of capitalization, banks are designated as "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized." A bank's capitalization designation is based on its total capital, tier 1 capital, and tier 1 leverage capital ratios. (See the definitions in 12 CFR 208.41.) Ultimately, the PCA statute was designed to impose mandatory and discretionary restrictions on banks that fall below the "adequately capitalized" level.

## 1995

Effective after the mid 1990s, the Federal Reserve intensified its focus on the importance of sound risk-management processes and practices as well as strong internal controls. System examiners were instructed to more thoroughly evaluate the bank's process for monitoring and controlling risk during an examination. Examiners began reporting a formal supervisory rating upon the conclusion of an examination pertaining to the adequacy of a bank's risk-management processes and internal controls. The rating provided a summary of the examiner's analysis and findings regarding the bank's overall processes for identifying, measuring, monitoring, and controlling risk. The rating incorporates the qualitative and quantitative aspects of risk management found during the examiners' review. See SR-95-51.[1]

## 1996

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 revised the Federal Reserve Act to permit well-capitalized and well-managed banks to invest amounts equal to 150 percent of capital and surplus in bank premises without prior Federal Reserve approval. The Federal Deposit Insurance Act (FDIA) was amended to mandate that each banking agency take the actions necessary to ensure that examiners consult and reach agreement on examination activities and resultant recommendations. The FDIA was amended to authorize a federal banking agency to permit an independent audit committee to be composed of a majority of outside directors, independent of the institution's management, if it determines that the depository institution has encountered hardships in retaining competent directors on such a committee.

## 1997

The emphasis on risk-focused supervision continued when the Federal Reserve issued SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions." Supervisory processes were developed that focused more effectively on an organization's primary risks and internal controls, and its process for managing and monitoring principal risks. The framework was designed for institutions with a functional management structure and a broad array of products, services, activities, and operations. This supervisory program is managed by an assigned central point of contact (CPC), assisted by a dedicated team of examiners who conduct target reviews of functional areas and product lines during a supervisory cycle.

More emphasis was given to a risk-focused supervisory framework for community banks. SR-97-25, "Risk-Focused Framework for the Supervision of Community Banks," details a framework that relies on examiner judgment when determining the scope of the examination during the planning process. Examiners are able to customize the examination procedures to be performed on site at the bank. The examiner-in-charge (EIC) outlines the risk profile of the bank and the exam activities.

## 1999

The Gramm-Leach-Bliley Act (GLB Act) amended the Banking Act of 1933. It repealed the prohibitions against (1) a Federal Reserve member bank affiliating with an entity engaged primarily in securities activities (securities affiliate) and (2) the simultaneous service by an officer, director, or employee at a securities firm and also a member bank (interlocking directorates). The statute amended federal banking law so that a national bank (thus, a state member bank) could control or hold an interest in a financial subsidiary. A financial subsidiary's activities are limited to those activities that are (1) financial in nature or incidental to a financial activity or (2) permissible for a national bank to engage in directly. A financial subsidiary is prevented from engaging in certain insurance or real estate development and investment activities.

## 2000

The risk-focused examination program continues with a concept of conducting, when appropriate, a series of targeted examinations within a supervisory cycle, with each examination focusing on an activity, business line, or legal entity. The examiner is also to consider a bank's information technology (IT) systems and con-

1. Supervision and Regulation letters, commonly known as SR letters, address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. These letters are issued by the Board's Division of Banking Supervision and Regulation and are a means of disseminating information to banking supervision staff at the Board and the Reserve Banks, as well as to supervised banking organizations.

trols when developing risk assessments and supervisory plans and when determining the level of examination review needed, given the characteristics, size, business activities, and complexity of the organization. Safety-and-soundness examiners and IT specialists closely coordinate their activities and the level of expertise needed during the risk-assessment and planning phase, as well as during on-site examinations.

The American Homeownership and Economic Opportunity Act of 2000 required the banking agencies to work together to develop (1) electronic filing and public dissemination of depository institution status reports (Call Reports) and (2) uniform formats and simplified filing instructions for Call Reports.

## 2001

Examiners were advised that the GLB Act authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell municipal revenue bonds without limitations relative to the bank's capital. Federal banking agency expectations were announced for documentation for the Allowance for Loan and Lease Losses (ALLL) methodology. Examiners were informed of the GLB Act's ownership and control provisions, the approval requirements, and permissible activities for financial subsidiaries and operating subsidiaries of state member banks. The GLB Act allowed banks to continue to retain new operations subsidiaries that are permitted under state law.

Examiners were advised of an increased emphasis on the review of a bank's information technology within the examination process. This includes a review of on-site electronic banking activities (new products and services; changes in the composition or level of customers, earnings, assets, or liabilities generated or affected; new or significant modified systems or outsourcing relationships; and business lines that rely heavily on electronic banking systems). Examiners are expected to focus on significant changes in the scope of services and the nature of operations.

## 2002

The Federal Reserve examination and supervisory staff and the financial institutions' board of directors and senior management were advised of supervisory guidance that was issued for the design and implementation of ALLL methodologies and documentation practices, tailored to the size and complexity of the institution and its loan portfolio. An institution's ALLL methodology must be a thorough, disciplined, and consistently applied process that includes management's current judgment about the quality of the loan portfolio. The institution must maintain, at a minimum, current written supporting documentation for its decisions, strategies, and processes.

Institutions are expected to recognize the elevated levels of credit risk and other risks arising from subprime lending practices. Institutions are to have strong risk-management practices, internal controls, and board-approved policies and procedures that appropriately identify, monitor, and control all risks associated with the activity. Such credit-extending activities necessitate (1) more vigilant risk-management practices and (2) additional capital.

Interpretive guidance was issued on the capital treatment of recourse obligations, direct-credit substitutes, and residual interests in asset securitization due to supervisory concern over the covenants in asset securitization agreements (contracts) that were linked to supervisory thresholds or adverse supervisory actions. A risk-based capital treatment was begun pertaining to a ratings-based qualification for certain corporate bonds or other unrated securities (those that are unrelated to an asset securitization or structured finance program). Guidance was issued on implicit recourse that is provided to asset securitization. The guidance demonstrated that the securitizing institution is reassuming risk associated with securitized assets—risk that the institution initially transferred to the marketplace.

The Sarbanes-Oxley Act (SOX) was enacted. It applies to publicly owned companies, which includes a small number of state member banks. These companies and banks have issued securities registered under section 12 of the Securities Exchange Act of 1934 or are required to file reports under section 15(d) of the 1934 Act. The SOX is concerned with specific mandates and requirements for financial reporting, including auditor independence, conflicts of interest, financial disclosure, corporate governance, criminal fraud, and accountability. Of particular importance for a state member bank is the internal control function, as it relates to auditor independence, financial disclosures, formation of an audit committee, and the attestation on the adequacy of internal controls. See sections 1010.1 and 4150.1.

## 2003

The Check Clearing for the 21st Century Act established a framework of special conditions under which a substitute check could be the legal equivalent of an original check. The primary considerations of the Fair and Accurate Credit Transactions Act (amended by the Fair Credit Reporting Act) were to prevent identity theft and provide for the restoration of a consumer's credit history. Another supervisory focus included an emphasis on authentication within an electronic banking environment—the assessment of the risks and establishing and maintaining the necessary risk-management measures and controls. Great emphasis was placed on the federal banking agencies issuing regulations that require the proper disposal of consumer information, or any compilation of it, that is derived from consumer reports. Certain institutions are to provide written notice to a consumer if they furnish negative information to a consumer reporting agency on credit extensions.

## 2004

The federal banking agencies adopted joint rules for disciplinary actions that may be taken against independent accountants and accounting firms that perform audit and attestation services that are required by the FDI Act for insured institutions having $500 million or more in assets. Attestation services address management assertions regarding internal controls over financial reporting.

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective independent appraisal and evaluation program for all lending functions in compliance with the 2003 interagency statement on Independent Appraisal and Evaluation Functions.

## 2005

The Federal Deposit Reform Act of 2005 increased the standard maximum deposit insurance from $100,000 to $250,000 for certain deposit retirement accounts.

Supervisory guidance was issued on the safety-and-soundness and risk-management implications of an institution's purchases and holdings of life insurance. The guidance was developed and issued in response to a concern that institutions may not have an adequate understanding of the risks associated with bank-owned life insurance (BOLI) holdings, including the liquidity, operational, reputational, and compliance risks. Institutions should not acquire a significant amount of BOLI holdings without properly assessing its associated risks. When an institution acquires BOLI that will result in an aggregate cash surrender value in excess of 25 percent of its tier 1 capital plus the ALLL, the prior approval of the board of directors or designated committee should be obtained. An institution should conduct comprehensive pre- and post-purchase analyses of BOLI, including its unique characteristics, risks, and rewards. There must be comprehensive risk-management processes for the institution's BOLI purchases and holdings, consistent with safe-and-sound banking practices.

Interagency guidance was issued on the Eligibility of Asset-Backed Commercial Paper (ABCP) Liquidity Facilities and the Resulting Risk-Based Capital Treatment. The guidance clarified the application of the asset-quality test for determining the eligibility or ineligibility of an ABCP liquidity facility and the resulting risk-based capital treatment of such a facility for banks. It re-emphasized that the primary function of an eligible ABCP liquidity facility was to provide *liquidity*—not credit enhancement. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are (1) 90 days or more past due, (2) in default, or (3) below investment grade, implying that the institution providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets.

## 2007

New standards set forth a revised risk-based capital framework for banking organizations. Institutions are to use internal ratings they assign to asset pools purchased by their asset-backed commercial paper programs. These ratings are used to assign a risk weight to any direct credit substitutes (such as guarantees) that are extended to such programs. Guidance is provided on evaluating direct credit substitutes that are issued as program-wide credit enhancements.