Federal Reserve System

Framework for Risk-Focused Supervision of Large Complex Institutions

This handbook contains references to hypothetical banking organizations. All financial information cited for these fictional organizations is purely illustrative.

August 8, 1997
FORWARD

The Federal Reserve has long recognized a difference in the supervisory requirements for community banks and large complex banking organizations. The complexity of financial products, sophistication of risk management systems (including audit and internal controls), management structure, and geographic dispersion of operations are but a few of the areas in which large institutions may be distinguished from community banks. In addition, while close coordination with state banking departments, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) is important for fostering consistency among banking supervisors and reducing burden for community banks, it is critical for large banking institutions. In particular, close coordination with the OCC is needed in the supervision of complex bank holding companies that have national bank subsidiaries. Accordingly, the Federal Reserve has traditionally, if informally, subjected large complex institutions and small institutions to different supervisory approaches. With the introduction of this framework for risk-focused supervision of large complex institutions and a parallel framework for community banks, the Federal Reserve is making the distinction between the supervisory approaches for the two types of organizations more formal than it has been in the past.

The examination approaches for both large complex institutions and community banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, development of a supervisory plan, and examination procedures tailored to the risk profile. However, the two approaches are implemented differently. For example, the process for complex institutions relies more heavily on a central point of contact and detailed risk assessments and supervisory plans prior to the on-site examination or inspection. In comparison, for small or noncomplex institutions and community banks, risk assessments and examination activities may be adequately described in the scope memorandum.

The risk-focused examination approach also incorporates the U.S. operations of foreign banking organizations (FBOs), for which the Federal Reserve has overall supervisory authority. However, these large complex organizations present special challenges in view of the fact that their operations outside the United States are not regulated or supervised by the Federal Reserve. Further, for U.S. branches and agencies of FBOs, the Federal Reserve is a host country supervisor rather than the home country consolidated supervisor. Thus, the risk-focused examination process needs to be carried out within the framework of the FBO program which fully accounts for these differences and was agreed to with other supervisors in 1995.
This handbook describes the Federal Reserve’s framework for the supervision of large complex institutions and should be used in conjunction with existing supervisory guidance and manuals. To assist the reader, relevant guidance has been incorporated into, or referenced in, the discussion. With the introduction of the risk-focused framework, functional examination modules which outline specific examination and inspection procedures are being developed and will replace the existing work documentation program for state member banks.

Questions or comments concerning this handbook should be addressed to:

Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, D.C. 20551
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I. INTRODUCTION

The Federal Reserve has introduced a number of programs aimed at enhancing the effectiveness of its supervisory process for banks and bank holding companies. The main objective of each of these initiatives has been to sharpen the supervisory focus on 1) those areas which pose the greatest risk to the soundness of banking organizations, and 2) on the assessment of management processes to identify, measure, monitor, and control risks. Although effective risk management has always been central to safe and sound banking activities, it has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. In response to these changing market realities, certain supervisory risk management processes have been refined, while others -- in particular, those that have proven most successful in supervising institutions under a variety of economic circumstances and industry conditions -- have been retained.

The framework for risk-focused supervision of large complex institutions, introduced in this handbook, is the result of the Federal Reserve's evolution to seamless, risk-focused supervision. Some of the previous key initiatives incorporated into this program are summarized below:

- The Federal Reserve implemented its supervisory program for foreign banking organizations (FBOs) in March 1995, and communicated the program to examiners in SR letter 95-22. The FBO program was tailored to meet the supervisory challenges of an environment in which a foreign institution may have extensive and diverse activities throughout the United States. Because these activities often involve a variety of legal entities operating across multiple jurisdictions, supervision of the institution can involve numerous regulators. The FBO program emphasizes coordination and cooperation among the regulators, an assessment of the strength of support provided by the FBO, and a risk-focused approach to examinations.

- A rating system for the adequacy of risk management processes and internal controls at state member banks and bank holding companies was implemented in November 1995 and communicated to examiners in SR letter 95-51. (Refer to Appendix A.) The increased supervisory emphasis on risk management processes reflects the view that properly managing risks is critical to the conduct of safe and sound banking activities.

- The importance of risk-focused examinations was reinforced with the issuance of SR letter 96-14 in May 1996. This supervisory letter emphasizes the importance of effective planning and scoping in order to customize examinations to the size and activities of financial institutions and to concentrate examiner resources on areas that expose an institution to the greatest degree of risk.

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1In this handbook, the word "examination" is used generally to refer to both the examination of a bank and the inspection of a bank holding company.
In May 1996, the Federal Reserve, the Conference of State Bank Supervisors (CSBS), and the FDIC issued the State/Federal Supervisory Protocol and Model Agreement. Under the protocol, the home state supervisor and the appropriate federal regulator will coordinate the supervision of interstate banks to ensure a risk-focused process and to reduce regulatory burden and overlap. The model agreement specifies the actions that the appropriate federal regulator and the home state supervisor will take to fulfill the goals of the protocol.

The Federal Reserve framework for supervising large institutions with interstate banking and branching activities was field tested from September 1996 to March 1997. The primary goals of the pilot program were to foster coordination and cooperation among Reserve Banks, state banking departments, and other federal agencies in order to provide seamless, risk-focused supervision and to eliminate duplication of efforts.

In November 1996, the Federal Reserve Board along with the FDIC and all of the state banking departments signed a Nationwide State/Federal Supervisory Agreement, which was based on the April 1996 Model Agreement. The Supervisory Agreement outlines a "best effort" supervisory approach.

Objectives of the Supervisory Process

The Federal Reserve is committed to ensuring that the supervisory process for all institutions under its purview meets the following objectives:

- **Provide flexible and responsive supervision.** The supervisory process is dynamic and forward looking so that it responds to technological advances, product innovation, and new risk management systems and techniques, as well as to changes in the condition of an individual financial institution and developments in the market.

- **Foster consistency, coordination, and communication among the appropriate supervisors.** Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process utilizes examiner resources effectively by using the institution's internal and external risk assessment and monitoring systems, making appropriate use of joint and alternating examinations, and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.

- **Promote the safety and soundness of financial institutions.** The supervisory process effectively evaluates the safety and soundness of banking institutions, including the assessment of risk management systems, financial condition, and compliance with laws and regulations.
• **Provide a comprehensive assessment of the institution.** The supervisory process integrates specialty areas (e.g., information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

**Key Elements of the Framework**

In order to meet the objectives discussed above and to respond to the characteristics of large institutions, the framework for risk-focused supervision of large complex institutions contains the following key elements:

• **Designation of a central point of contact:** Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the program requires that a "central point of contact" be designated for each institution to facilitate coordination and communication among the numerous regulators and specialty areas.

• **Review of functional activities:** Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and used to support the supervisory ratings for individual legal entities.²

• **Focus on risk management processes:** Large institutions generally have highly developed risk management systems such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution's responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution's risk management systems, yet retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective is more dynamic and forward looking because it provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges.

²Where functions are located entirely in legal entities that are not primarily supervised by the Federal Reserve, the results of supervisory activities conducted by the primary regulator will be utilized to the extent possible to avoid duplication of activities.
Tailoring of supervisory activities: Large institutions are unique, but all possess the ability to quickly change their risk profiles. In order to deliver effective supervision, the program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution’s major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution’s condition.

Emphasis on ongoing supervision: Large institutions face a rapidly changing environment. Therefore, the supervisory program emphasizes ongoing supervision through increased planning and off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution and the economy.

Institutions Covered by the Framework

For purposes of the risk-focused supervision framework, large complex institutions generally have a functional management structure, a broad array of products, operations that span multiple supervisory jurisdictions, and consolidated assets of $1 billion or more. These institutions may be state member banks, bank holding companies (including their nonbank and foreign subsidiaries), and branches and agencies of foreign banking organizations. However, if an institution with consolidated assets totaling $1 billion or more does not have these characteristics, the supervisory process adopted for community banks may be more appropriate. (The supervisory program for small institutions is presented in a separate document.) Conversely, the complex institution process may be appropriate for some organizations with consolidated assets less than $1 billion. This may be particularly relevant with respect to U.S. branches and agencies of FBOs in light of the general nature of their activities.

Foreign Institutions: Because U.S. supervisory authorities are host country rather than home country supervisors for most of the U.S. operations of FBOs, the supervisory focus and objectives are somewhat different for U.S. operations of FBOs and are presented separately in the FBO supervision program. However, the desired result of a risk-focused examination process should be the same. This handbook presents supervision and examination processes and procedures relevant to the U.S. operations of FBOs to the extent appropriate. Any significant remaining differences are incorporated in the FBO supervision program or will be addressed in separate guidance.

Nonbank Subsidiaries of Domestic Institutions: Nonbank subsidiaries of large complex domestic institutions are covered by this program, including: nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; the significant branch operations, primarily foreign branches, of state member banks; and subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign

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3Large institutions are defined differently in other regulatory guidance regarding regulatory reports and examination mandates.
branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization or the state member bank. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk assessment process presented in this handbook, and the appropriate level of supervisory coverage, whether on-site or off-site, should be described in the supervisory plan for the organization. Appendix B - Nonbank Subsidiary of a Bank Holding Company Risk Assessment Questionnaire provides a guide for determining whether nonbank subsidiaries pose significant risk to the parent bank holding company. Additionally, the supervisory plan for the organization should include a review of the institution's processes to ensure compliance with sections 23A and 23B of the Federal Reserve Act and various other regulations and guidelines that govern transactions between the bank and nonbank affiliates.

**Edge Act corporations:** Under section 25(a), paragraph 19, of the Federal Reserve Act, Edge Act corporations are subject to examination once a year and at such other times as deemed necessary by the Federal Reserve. While Reserve Banks must fulfill this legal mandate, there is flexibility in determining the extent of examination coverage. The scope of Edge Act corporation examinations should be determined through the risk assessment process. Additionally, separate reports of examination are not required for Edge Act corporations, provided that all relevant findings are included in the consolidated report of examination of the parent bank. This reporting procedure also applies to other nonbank subsidiaries of the bank or bank holding company.

**Specialty Areas Covered by the Framework**

The Federal Reserve conducts examinations or reviews of several specialty areas on a regular basis. To achieve more efficient supervision and to reduce the regulatory burden on institutions, steps have been taken to coordinate these reviews with the annual full-scope examination of the consolidated organization. Under the risk-focused approach, the specialty areas should be included in the planning process in relation to the perceived level of risk to the consolidated organization or any state member bank subsidiary. Reviews of any specialty areas can be performed in conjunction with the annual full-scope inspection, or through targeted examinations, at any time during the supervisory cycle, as described under Section III - Functional Approach and Targeted Examinations.

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4With the implementation of the risk-focused supervision approach, separate risk assessments of nonbank subsidiaries of domestic bank holding companies are no longer required, but should be reflected in the consolidated organization's risk assessment. As a result, SR letter 93-19 which contained the requirement for a risk assessment of the nonbank has been partially superseded by issuance of this handbook. However, the remaining guidance contained in SR letter 93-19, pertaining to nonbank inspection frequency guidelines and on-site reviews of nonbank subsidiaries and off-site reviews of nonbank activities, is still effective.

5A separate memorandum to the file should be prepared that provides the date of examination of the Edge Act corporation, a summary of findings, the rating assigned, and a reference to the consolidated report of examination. This information should also be forwarded to Federal Reserve Board staff.

6Separate supervisory ratings and examination frequency cycles are under review for the specialty areas.
The findings of all specialty reviews should be included in the report of examination of the consolidated organization.

Appendix C provides a general examination frequency schedule for several specialty areas in which the Federal Reserve currently performs examination activities. At a minimum, the examination of these specialty areas should meet these frequency guidelines. The scope of coverage should be determined according to the perceived level of risk with the exception of the following:

- Under rule G-16 of the Municipal Securities Rulemaking Board (MSRB), an examination of registered municipal securities brokers and dealers at state member banks must be conducted at least once every 24 months. The Federal Reserve is required to forward findings of these examinations to the Securities and Exchange Commission (SEC); therefore, a separate report of examination will continue to be needed.

- The Summary Report of Examination of Government Securities Broker/Dealer or Custodial Activities must be completed as part of each full-scope examination conducted by the Federal Reserve. The report must be submitted to the Treasury Department.

- A review of compliance with the Bank Secrecy Act (BSA) must be completed as part of each full-scope examination conducted by the Federal Reserve.  

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Refer to the BSA Manual for additional information concerning Treasury Department requirements.
II. COORDINATION OF SUPERVISORY ACTIVITIES

Many large complex institutions have interstate operations which will be expanded with the continuation of mergers and acquisitions. Moreover, interstate branching of state member banks will likely result in the conversion of many existing independent banks into branches that cross state and district lines. As banks convert to branches, the resulting branches are no longer subject to separate safety and soundness examinations. In this environment, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the Responsible Reserve Bank with the central point of contact or the Local Reserve Bank.

Consistent with current practices, Local Reserve Banks and Host States will not routinely examine branches of state member banks or issue separate ratings and reports of examination. Similar to the relationship between the Responsible and Local Reserve Banks, Home State Supervisors will coordinate the activities of all state banking departments and will be the states’ principal source of contact with the federal banking agencies and with the bank itself. It also provides that Host States will not unilaterally examine branches of interstate banks.

Responsible Reserve Bank

The traditional role of the Responsible Reserve Bank was expanded in 1996 to facilitate the increased flexibility, planning, and coordination needed to effectively and efficiently supervise institutions with interstate operations. Considering the overriding objectives of seamless, risk-focused supervision of interstate organizations, the Responsible Reserve Bank is now responsible for designating the central point of contact and for ensuring that all aspects of the supervisory process are fully coordinated with Local Reserve Banks and Home State Supervisors.

To the extent possible, the Responsible Reserve Bank should continue to rely on Local Reserve Banks to provide the resources to conduct examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of FBOs. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision. For further guidance, refer to SR letters 93-48, 89-25, and 78-464.

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8The State/Federal Supervisory Protocol and Agreement established definitions for Home and Host States. The Home State Supervisor is defined as the state that issued the charter. It will act on behalf of itself and all Host State Supervisors (states into which the bank branches) and will be the single state contact for a particular institution.
Local Reserve Banks

In general, Local Reserve Banks are responsible for the direct supervision of state member banks located in their district. In addition, the Local Reserve Bank provides the resources to the Responsible Reserve Bank to conduct the inspections of second-tier, domestic bank holding companies, nonbank subsidiaries, and branches and agencies of FBOs for top-tier holding companies located in the Responsible Reserve Bank’s district. If the functional management of a banking organization is headquartered in its district, the Local Reserve Bank may also be called upon to conduct functional business line reviews which is discussed more fully in Section III - Functional Approach and Targeted Examinations. However, if a state member bank is owned by an out-of-district domestic holding company or if the responsibility for the supervision of the overall U.S. operations of the FBO lies with another Reserve Bank, the supervision of that entity should be coordinated by the Responsible Reserve Bank.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the Responsible Reserve Bank for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

Central Point of Contact

A central point of contact is critical to fulfilling the objectives of seamless, risk-focused supervision. The Responsible Reserve Bank should designate a central point of contact for each large complex institution it supervises. Generally, all activities and duties of other areas within the Federal Reserve, as well as with other supervisors, should be coordinated through this contact. The central point of contact should:

- Be knowledgeable, on an ongoing basis, about the institution’s financial condition, management structure, strategic plan and direction, and overall operations.
- Remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities, monitoring and surveillance information, applications issues, capital markets activities, meetings with management, and enforcement issues, if applicable.
- Ensure that the objective of seamless, risk-focused supervision is achieved for each institution and that the supervisory products (i.e., an institutional overview, risk matrix, risk assessment, supervisory plan, examination program, scope memorandum, examination modules, and report of examination) are prepared in a timely manner.
- Ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance.
• Participate in the examination process, as needed, to ensure consistency with the institution's supervisory plan and effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and to facilitate requests for information from the institution, wherever possible.

Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. Information to be shared should include the products that are described in this handbook. Sharing of these products with the institution, however, should be carefully evaluated on a case-by-case basis. The institutional overview, risk assessment, and supervisory plan may not be appropriate for release if they contain a hypothesis about the risk profile of the institution rather than assessments verified through the examination process. On the other hand, it may be appropriate to share the examination program with the institution in the interest of better coordinating examination activities.

Coordination with Other Supervisors

Section 305 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI) directed the agencies to the extent possible to coordinate examinations when they are jointly responsible for examination of various entities of a bank holding company. In a December 1996 letter to the House Committee on Banking and Financial Service, the agencies outlined their cooperative efforts to meet the objectives of section 305. To help achieve the desired degree of coordination, staffs of the agencies are expected, primarily at the regional level, to discuss examination plans and coordination issues. The institution involved is to be kept fully informed of the coordinated activities planned by the agencies, including a general time frame in which each agency is expecting to conduct its examination activities.

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9The FBO supervision program identifies several products to be shared with other U.S. supervisory authorities: a review of the home country financial system, a review of significant home country accounting practices, a strength of support assessment of the FBO, a summary of condition of U.S. operations, and comprehensive and individual examination plans. Refer to SR letter 95-22 (SUP. IB).


III. FUNCTIONAL APPROACH AND TARGETED EXAMINATIONS

Traditionally, the examination process has been largely driven by a legal entity approach to banking companies. The framework for risk-focused supervision of large complex institutions relies more heavily on a functional, business line approach to supervising institutions, while effectively integrating the functional approach into the legal entity assessment.

Bank holding companies are increasingly being managed on a functional basis. Such functional management allows organizations to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders. Virtually all of the large bank holding companies now operate as integrated units and are managed as such. For these companies, the risk management systems are generally organized along business lines on a centralized basis. A key implication of this shift in management structure is that much of the information and insight gathered on examinations of individual legal entities can only be fully understood in the context of examination findings of other related legal entities or centralized functions. Developing that understanding means adapting some of the same functional business line approaches to supervision, including examination processes. Consequently, this risk-focused supervision framework incorporates risk assessments and examination procedures that are organized by function.

The functional approach focuses principally on the key business activities (e.g., lending, treasury, retail banking) rather than reviewing the legal entity and its balance sheet. This does not mean that the responsibility for a legal entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions for which other regulators have primary supervisory responsibility. Rather, Federal Reserve examiners should integrate the findings of a functional review into the legal entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and possibly transaction testing at all levels of the organization.

Functional risk-focused supervision is to be achieved by:

- Planning and conducting joint examinations with the primary regulator in areas of mutual interest such as nondeposit-investment products, interest rate risk, liquidity, and mergers and acquisitions.
- Leveraging off the work performed by the primary regulator and the work performed by the institution’s internal and external auditors by reviewing and using their work papers and conclusions to avoid duplication of effort and burden to the institution.

With respect to U.S. banks owned by FBOs, it is particularly important to review the U.S. bank on a legal entity basis and the risk exposure to the U.S. bank of its parent foreign bank since U.S. supervisory authorities do not supervise or regulate the parent bank.
• Reviewing reports of examinations and other communications to the institution issued by other supervisors.

• Conducting a series of functional reviews or targeted examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle. Functional reviews and targeted examinations are increasingly necessary to evaluate the relevant risk exposure of a large complex institution and the effectiveness of related risk management systems.

The relevant findings of functional reviews or targeted examinations should be:

• Incorporated into the annual full-scope examination. In this context, a full-scope activity involves the analysis of data sufficient to determine the safety and soundness of the institution and to assign supervisory ratings. The examination procedures required to arrive at those determinations do not necessarily have to be performed at the time of the annual examination, but can be a product of the collective activities performed throughout the supervisory cycle. However, examination procedures should contain follow-up on deficiencies noted in functional reviews or targeted examinations.

• Conveyed to the institution’s management during a close-out or exit meeting with the relevant area line management. The need to communicate the findings to senior management or the board of directors is left to the judgment of Reserve Bank management based on the significance of the findings.

• Communicated in a formal written report to the institution’s management or board of directors when significant weaknesses are detected or when the findings result in a downgrade of any rating component. Otherwise, the vehicle for communicating the results is left to the judgment of Reserve Bank management and may either be a formal report or a supervisory letter.

The functional approach to risk assessments and planning supervisory activities should include a review of the parent company and its significant nonbank subsidiaries. However, it is anticipated that the level of supervisory activities, on-site or off-site, will be appropriate to the risk profile of the

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11A supervisory cycle is the period of time from the close of one annual examination to the close of the following annual examination.

12As discussed in SR letter 92-31, it is currently Federal Reserve System practice to update BOPEC ratings between inspections to keep them current and to ensure that they reflect the latest information on the institution’s financial condition. For state member banks, current policy dictates that Reserve Banks refrain from revising CAMELS ratings based on off-site analysis in view of the emphasis being placed on the CAMELS ratings for implementing risk-based insurance assessments and other supervisory initiatives. In accordance with SR letter 96-26, Reserve Banks should notify the institution’s management whenever the rating is changed as a result of off-site analysis.
parent company or its nonbank subsidiary in relation to the consolidated organization. Intercompany transactions should continue to be reviewed as part of the examination procedures performed to ensure that they comply with laws and regulations and do not pose safety and soundness concerns.
IV. OVERVIEW OF THE PROCESS AND PRODUCTS

The risk-focused methodology for the supervision program for large complex institutions reflects a continuous and dynamic process. As described in the table below, this methodology is comprised of six key steps, each of which uses certain written products to facilitate communication and coordination.

<table>
<thead>
<tr>
<th>STEPS</th>
<th>PRODUCTS</th>
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<tr>
<td>1. Understanding the Institution</td>
<td>1. Institutional Overview</td>
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<td>3. Risk Assessment</td>
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<td>3. Planning and Scheduling Supervisory Activities</td>
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With the exception of the entry letter, the written products associated with steps 1 through 4 are relatively new to the supervision process. The intent of these new products is to sharpen the supervisory focus on those business activities of an institution that pose the greatest risk, and to assess the adequacy of the institution’s risk management systems to identify, measure, monitor, and control risks. As this is a dynamic process, the products should be revised as new information is received from such sources as the current examination, recent targeted examinations, and periodic reviews of regulatory reports.

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process, and not on just simply completing the products. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and the structure and complexity of the institution. Each step is discussed in detail in subsequent sections of this handbook.
V. UNDERSTANDING THE INSTITUTION

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and adjusting that program on an ongoing basis as circumstances change. It is also essential to clearly understand the Federal Reserve’s supervisory role vis-a-vis an institution and its affiliates. For example, the Federal Reserve's role pertaining to a FBO will vary depending upon whether the Federal Reserve is the Home or Host Country Supervisor for the particular legal entity. Therefore, it follows that planning and monitoring are key components.

Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and related supervisory concerns. Given the technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change, it is critical to keep abreast of events and changes in risk exposure and strategy. Accordingly, the central point of contact for each large complex institution should review certain information on an ongoing basis and prepare an institutional overview that will communicate the contact's understanding of that institution.

Sources of Information

Information generated by the Federal Reserve, other supervisors, the institution, and public organizations may assist the central point of contact in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. For example, the Federal Reserve maintains a significant amount of financial and structure information in various automated data bases. In addition, prior reports of examinations are excellent sources of information regarding previously identified problems.

Each Reserve Bank has various surveillance reports that identify outliers when an institution is compared to its peer group. The Uniform Bank Performance Report, or Bank Holding Company Performance Report, may identify significant deviations in an institution's performance relative to its peer group and between examinations of the institution. For branches and agencies, state member banks, and domestic bank holding companies that are part of FBOs, the Strength of Support Assessment (SOSA) rating and relevant credit assessments from major rating agencies provide information that needs to be considered in developing an appropriate supervisory strategy. For FBOs, the Federal Reserve has developed an automated system, referred to as the FBO Desktop, that provides information on foreign financial systems, foreign accounting standards, and the financial performance of FBOs with U.S. operations.

Leveraging off the work, knowledge, and conclusions of other supervisors is of key importance to understanding a large complex organization. Ongoing contact and the exchange of information with other supervisors who have responsibilities for a given institution may provide insight into the institution that cannot be obtained from other sources. Additional information can
be obtained from examination reports issued by other supervisors and their databases [e.g., the OCC’s Supervisory Monitoring System (SMS) and the FDIC’s Bank Information Tracking System (BITS)].

Using information generated by the institution’s management information system improves the supervisory process. It provides an efficient way to reduce on-site time, identify emerging trends, and remain informed about the activities of the institution and financial markets. Information that may be periodically reviewed by the contact includes the size and composition of intraday balance sheets, internal risk ratings of loans, internal limits and current risk measures regarding trading activities, and internal limits and measures covering the institution’s interest rate and market risk. Additionally, functional organization charts reflecting the major lines of business across legal entities, changes to the organization’s strategic plan, and information provided to the board of directors and management committees should be reviewed.

The central point of contact should also hold periodic discussions with the institution’s management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. Where other agencies have supervisory responsibilities for the organization, joint meetings should be considered.

Publicly available information may provide additional insight into an institution’s condition. This may be particularly valuable in assessing an organization’s ability to raise capital. Public sources of information include SEC reports, press releases, and analyses by private rating agencies and securities dealers and underwriters.

**Preparation of the Institutional Overview**

The institutional overview should provide an executive summary that communicates, in one concise document, information demonstrating an understanding of the institution’s present condition and its current and prospective risk profiles as well as highlights key issues and past supervisory findings. A sample institutional overview is included in Appendix D. General types of information that may be valuable to present in the overview include:

- A brief description of the organizational structure, with comments on the legal and business units, and changes through merger, acquisition, divestitures, consolidation, or charter conversion since the prior review.

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13The following list is provided in the context of institutions for which the Federal Reserve is the home country supervisor. In the case of an FBO, the analysis should begin with the Strength of Support Assessment and the Summary of Condition of U.S. operations. Further guidance will be issued with respect to any modifications to be made to any products utilized in the FBO supervision program as discussed in SR letter 95-22 (SUP.IB).
• A summary of the organization’s business strategies, key business lines, product mix, marketing emphasis, growth areas, acquisition or divestiture plans, and new products introduced since the prior review.

• Key issues for the organization, either from external or internal factors (e.g., difficulties in keeping pace with competition, poorly performing business lines).

• An overview of management, commenting on the level of board oversight, leadership strengths or weaknesses, policy formulation, and the adequacy of management information systems. Comments should include anticipated changes in key management, unusual turnover in line management, and management succession plans. Key executives and the extent of their participation in strategic planning, policy formulation, and risk management may also be described.

• A brief analysis of the consolidated financial condition and trends, including earnings, invested capital, and return on investment by business line.

• A description of the future prospects of the organization, expectations or strategic forecasts for key performance areas, and budget projections.

• Descriptions of internal and external audit, including the nature of any special work performed by external auditors during the period under review.

• A summary of supervisory activity performed since the last review, including: safety and soundness examinations, inspections, and targeted or specialty examinations; supervisory actions and the institution’s degree of compliance; and applications approved or in process.

• Considerations for conducting future examinations, including the institution’s preference for the coordination of specialty examinations and combined examination reports, as well as logistical and timing considerations, including conversion activities, space planning, and management availability.
VI. ASSESSING THE INSTITUTION’S RISKS

In order to focus supervisory activities on the areas of greatest risk to an institution, the central point of contact or designated staff personnel should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution, including:

- **Credit** risk, which arises from the potential that a borrower or counterparty will fail to perform on an obligation.

- **Market** risk, which is the risk to a financial institution’s condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.

- **Liquidity** risk, which is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").

- **Operational** risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

- **Legal** risk, which arises from the potential that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a banking organization.

- **Reputational** risk, which is the 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.

An institution’s business activities present various combinations and concentrations of these risks depending on the nature and scope of the particular activity. Therefore, when conducting the risk assessment, consideration must be given to the institution’s overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities. As discussed later, the preparation of the risk matrix provides a structured approach to assessing an institution’s risks and is the basis for preparing the narrative risk assessment. Refer to SR letter 95-51, contained in Appendix A, for additional guidance on the evaluation of an institution’s risk management.
Assessment of the Overall Risk Environment

The starting point in the risk assessment process is an evaluation of the institution’s risk tolerance and management’s perception of the organization’s strengths and weaknesses. Such an evaluation should entail discussions with management and review of supporting documents, strategic plans, and policy statements. In general, management is expected to have a clear understanding of both the institution’s markets and the general banking environment and how these factors affect the institution (e.g., use of its technology, products, and delivery channels).

The institution should have a clearly defined risk management structure. It may be formal or informal, centralized or decentralized. However, the greater the risk assumed by the institution, the more sophisticated its risk management system should be. Regardless of the approach, the types and levels of risk an institution is willing to accept should reflect the risk appetite determined by its board of directors.

Evaluate Internal Risk Management

In assessing the overall risk environment, the central point of contact should make a preliminary evaluation of the institution’s internal risk management. This includes an assessment of the adequacy of the institution’s internal audit, loan review, and compliance functions. External audits also provide important information regarding the risk profile and condition of the institution that may be used in the risk assessment. In completing this evaluation, Reserve Banks should consider holding meetings with the external auditor and senior management responsible for internal audit, loan review, and compliance, as well as with other key risk managers. As appropriate, the meetings should be held jointly with a representative from other supervisory agencies that have an interest in the institution.

In addition, the central point of contact or designated staff personnel should consider reviewing risk assessments developed by the internal audit department for significant lines of business and comparing the results with the supervisory risk assessment. Further, the contact should consider evaluating management’s ability to aggregate risks on a global basis. This preliminary evaluation can be used to determine the level of reliance that examiners can place on the institution’s internal risk management in developing the scope of examination activities.

Consider Adequacy of Information Technology Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by management information systems (MIS) that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Such systems must also provide managers engaged in the day-to-day management of the organization’s activities with regular and sufficiently detailed reports for their area of responsibility. Moreover, in most large complex institutions MIS not only provides reporting systems, but also supports a broad range of business decisions through sophisticated risk management and decision tools such as credit-scoring and asset/liability models and automated trading systems. Accordingly, the risk assessment
of the institution must consider the adequacy of information technology systems (formerly referred to as electronic data processing, or EDP).

Such consideration requires making a determination as to which business unit or units are responsible for the development and operation of the information technology system. Traditionally, such systems were largely centered on mainframe computers. However, the development of increasingly powerful and inexpensive personal computers and sophisticated network communication capabilities has allowed institutions to access a greater volume of information in a more timely manner to support a broader range of business decisions and move some transaction processing out of the mainframe environment. Consequently, many large institutions are transferring responsibility for development and operation of the hardware (generally, a local-area or wide-area network) and the related operating systems and applications from a centralized, mainframe function to individual business units. Many of these institutions are also integrating the information technology audit function with the general internal audit function.

Once a determination has been made as to which business units are responsible for information technology, a fuller understanding of the risk profile of specific functions and of the consolidated organization can be gained through close coordination between information systems specialists and safety and soundness examiners. In particular, since business managers must have MIS reports that are sufficient and appropriate for identifying risks, examiners must work with specialists to assess the adequacy of the information technology system and the extent to which it can be relied upon. Evaluating the integrity of the information contained in such reports requires an understanding of the information flows and the control environment for the operation. Knowledge of the business application is essential to determine whether the information flows are complete, accurate, and appropriate in a particular MIS. In addition, such a determination requires an assessment of the extent to which the institution’s internal audit function has procedures in place for reviewing and testing the effectiveness of the processes and internal controls related to information technology systems.

**Preparation of the Risk Matrix**

A risk matrix is used to identify significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities, as well as to determine composite risk assessments for each of these activities and the overall institution. A sample risk matrix is presented in Appendix E. A risk matrix can be developed for the consolidated organization, for a separate affiliate, or along functional business lines. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and serves as a basis for preparation of the narrative risk assessment.

**Identify Significant Activities**

Activities, and their significance, can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. Information generated by the institution may include the balance sheet, off-balance-sheet reports, the income statement, management accounting
reports, or any other report that is prepared for the institution’s board of directors and senior management to monitor performance. A detailed income statement is particularly informative because significant activities and their relative importance to the institution’s revenue and net income are reflected in this statement. The income statement also yields information regarding the relationship between the return on individual assets and the inherent risk associated with these assets, providing an important indicator of the institution’s overall risk appetite.

Off-site surveillance information is another source of information that can be used to identify new or expanding business activities. For example, substantial loan portfolio growth may indicate that the institution has introduced a new lending activity.

In addition to financial factors, information on strategic plans, new products, and possible management changes need to be considered. The competitive climate in which the institution operates is very important and should be assessed in the identification of significant activities. Industry segmentation and the position the institution occupies within its markets should also be considered.

**Identify Type and Level of Inherent Risk of Significant Activities**

After the significant activities are identified, the type and level of risk inherent in those activities should be determined. Types of risk may be categorized according to SR letter 95-51 as previously described in this section or by using categories defined either by the institution or by other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

The following table illustrates risk types as defined by the Federal Reserve and the OCC. The FDIC is currently considering the definition of risk types.
 surreal risk or activities, the inherent risk involved in that activity should be
described as high, moderate, or low for each type of risk associated with that activity. For example,
it may be determined that a portfolio of commercial loans in a particular institution has high credit
risk, moderate market risk, moderate liquidity risk, low operational risk, low legal risk, and low
reputational risk. The following definitions apply:

- **High inherent risk** exists where the activity is significant or positions are large in
relation to the institution's resources or to its peer group, where there are a substantial
number of transactions, or where the nature of the activity is inherently more complex
than normal. Thus, the activity potentially could result in a significant and harmful
loss to the organization.

- **Moderate inherent risk** exists where positions are average in relation to the
institution's resources or to its peer group, where the volume of transactions is
average, and where the activity is more typical or traditional. Thus, while the activity
potentially could result in a loss to the organization, the loss could be absorbed by the
organization in the normal course of business.

- **Low inherent risk** exists where the volume, size, or nature of the activity is such that
even if the internal controls have weaknesses, the risk of loss is remote or, if a loss
were to occur, it would have little negative impact on the institution's overall financial
condition.

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15Elements of strategic risk are reflected in each of the risk categories as defined by the Federal Reserve.
It is important to remember that this assessment of risk is made without considering management processes and controls; rather, these factors are considered in evaluating the adequacy of the institution’s risk management systems.

Assess Adequacy of Risk Management for Significant Activities

When assessing the adequacy of an institution’s risk management systems for identified functions or activities, the central point of contact or designated staff personnel should place primary consideration on findings related to the following key elements of a sound risk management system:

- Active board and senior management oversight;
- Adequate policies, procedures, and limits;
- Adequate risk management, monitoring, and management information systems; and
- Comprehensive internal controls.

Taking these key elements into account, the contact should assess the relative strength of the risk management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below.

**Strong risk management** indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.

**Acceptable risk management** indicates that the institution’s risk management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution’s business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.

**Weak risk management** indicates risk management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal
control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

While these definitions are intended to apply to the risk management of individual functions or activities, they parallel the definitions set forth in SR letter 95-51 that examiners use to rate an institution’s overall risk management. However, unlike, the overall risk management rating, the assessment of the adequacy of risk management systems incorporated into the risk matrix is to be used primarily for planning supervisory activities. In addition, because the risk matrix is prepared during the planning process, it generally would not be appropriate to make fine gradations in the strength of risk management systems on a function-by-function basis. In particular, for purposes of rating an institution’s overall risk management, SR letter 95-51 makes distinctions in degrees of weakness -- fair, marginal, and unsatisfactory -- that largely cannot be appropriately made on a function-by-function basis as called for in the preparation of the risk matrix. Nonetheless, after appropriate examination procedures are preformed, the assessment of the institution’s risk management prepared for the risk matrix may serve as a starting point for assigning an overall risk management rating for the institution. Refer to Appendix A for the guidance set forth in SR letter 95-51.

Assess Composite Risk of Significant Activities

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate. The following grid provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls.
### Composite Risk for Significant Activities

<table>
<thead>
<tr>
<th>RISK MANAGEMENT SYSTEMS</th>
<th>INHERENT RISK OF THE ACTIVITY</th>
<th>Composite Risk Assessment</th>
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<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>Weak</td>
<td>Low or Moderate</td>
<td>Moderate or High</td>
</tr>
<tr>
<td>Acceptable</td>
<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>Strong</td>
<td>Low</td>
<td>Low or Moderate</td>
</tr>
</tbody>
</table>

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided below.

- **A high composite risk** generally would be assigned to an activity where the risk management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, even in some cases where the systems are considered strong. For an activity with moderate inherent risk, a risk management system that has significant weaknesses could result in a high composite risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.

- **A moderate composite risk** generally would be assigned to an activity with moderate inherent risk where the risk management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk management system may result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.

- **A low composite risk** generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk where internal controls and risk management systems are strong and effectively mitigate much of the risk.
Assess Overall Composite Risk

Once the examiner has assessed the composite risk of each identified significant activity or function, an overall composite risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix, and the evaluation of the overall composite risk is incorporated into the written risk assessment.

Preparation of the Risk Assessment

A written risk assessment should be prepared to serve as an internal supervisory planning tool and to facilitate communication with other supervisors. A sample risk assessment is included in Appendix F. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, delineating the areas of supervisory concern and serving as a platform for developing the supervisory plan.

The format and content of the document are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution and, therefore, should consider the institution’s evolving business strategies and be amended as significant changes in the risk profile occur. It should include input from other affected supervisors and specialty units in order to ensure that all significant risks of the institution are identified. The risk assessment should:

- Include an overall risk assessment of the organization.
- Describe the types (credit, market, liquidity, reputational, operational, legal), level (high, moderate, low), and direction (increasing, stable, decreasing) of risks.
- Identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate and the key issues that could affect the risk profile.
- Consider the relationship between the likelihood of an adverse event and the potential impact on an institution (e.g., the likelihood of a computer system failure may be remote, but the financial impact could be significant).
- Describe the institution’s risk management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the ability of the institution to take on and manage risk prospectively.

The central point of contact should attempt to identify the cause of unfavorable trends, not just report the symptoms. For example, if an institution’s liquidity risk is increasing because of declining core deposits, the reasons for this decline in core deposits should be addressed. By identifying the cause of the decline, the contact will be able to assess the prospects for a reversal of the decline.
It is important that the risk assessment reflect a thorough analysis leading to conclusions regarding the institution’s risk profile rather than a reiteration of the facts. For example, it is not sufficient to merely report a high loan-to-deposit ratio as a liquidity concern. The contact should carefully analyze the liability structure to form a judgement about the seriousness of the concern. The significance of a relatively high loan-to-deposit ratio in an institution whose liabilities are virtually all highly stable core deposits is possibly less of a concern than the same ratio in an institution with a highly volatile liability structure. Liquidity risk might be high in the latter situation and moderate or low in the former, even though the ratio is the same.
VII. PLANNING AND SCHEDULING SUPERVISORY ACTIVITIES

The supervisory plan represents a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and examination schedule, the central point of contact should minimize disruption to the institution and, whenever possible, avoid duplicative examination efforts and similar information requests of the other supervisors.16

The institution's organizational structure and complexity represent significant considerations in planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site reviews. The scope and location of on-site work for interstate banking operations will depend upon the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. Consistent with Federal Reserve practice of not examining each branch of an intrastate branching network, it is likely that the bulk of safety and soundness examinations for branches of an interstate bank would be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

Preparation of the Supervisory Plan

A comprehensive supervisory plan17 should be developed annually and updated as appropriate for the consolidated organization. A sample supervisory plan is presented in Appendix G. The plan should demonstrate that supervisory concerns identified through the risk assessment process and the deficiencies noted in the previous examination are being, or will be, addressed. To the extent that the institution's risk management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address:

- Prioritizing supervisory resources on areas of higher risk.

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16 Refer to SR letter 93-30 for guidance on examination coordination of holding company inspections with subsidiary bank and thrift examinations, and SR letter 95-22 (SUP) regarding coordination with other agencies as part of the FBO supervision program.

17 The supervisory plan is a high level plan of supervisory activities to be conducted in monitoring the consolidated organization. More detailed procedures for a specific on-site examination are appropriately addressed in a scope memorandum, which is discussed in Section VIII -- Defining Examination Activities.
- Pooling examiner resources to reduce burden and redundancies.

- Maximizing the use of examiners located where the activity is being conducted.

- Coordinating examinations of different disciplines.

- Determining compliance with, or potential for, supervisory action.

- Balancing mandated requirements with the objectives of the plan.

- General logistical information (e.g., timetable of supervisory activities, participants, and expected resource requirements).

- The extent to which internal and external audit, internal loan review, compliance, and other risk management systems will be tested and relied upon.

The planning horizon to be covered by the plan is generally 18 months for domestic institutions. The overall supervisory objectives and basic framework need to be outlined by mid-year to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve’s annual scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

### Preparation of the Examination Program

The examination program should provide a comprehensive schedule of examination activities for the entire organization and aid in the coordination and communication of responsibilities for supervisory activities. A sample examination program is presented in Appendix H. Previously, each state and federal banking supervisor developed an independent schedule. In addition, schedules for specialty examinations were generally independent from safety and soundness schedules. An examination program provides a comprehensive listing of all examination activities to be conducted at an institution for the given planning horizon. In order to prepare a complete program and to reflect the current conditions and activities of an institution and activities of other supervisors, the central point of contact needs to be the focal point for communications on a particular institution, including any communications with the Federal Reserve and the institution’s management and other supervisors. The examination program generally incorporates the following logistical elements:
- A schedule of activities, duration of time, and resource estimates for planned projects.

- An identification of the agencies conducting and participating in the supervisory activity (where joint, indicate lead agency and the agency responsible for a particular activity) and resources committed by all participants to the area(s) under review.

- The planned product for communicating findings (indicate whether a formal report or supervisory memorandum).

- The need for special examiner skills and the extent of participation by specialty disciplines.
VIII. DEFINING EXAMINATION ACTIVITIES

The scope memorandum is an integral product in the risk-focused methodology as the memorandum identifies the key objectives of the on-site examination. The focus of on-site examination activities, identified in the scope memorandum, should be oriented to a top-down approach that includes a review of the organization's internal risk management systems and an appropriate level of transaction testing. The risk-focused methodology provides flexibility in the amount of on-site transaction testing. Although the focus of the examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems. If internal systems are considered reliable, then transaction testing should be targeted to a level sufficient to validate that the systems are effective and accurate. Conversely, if internal management systems are deemed unreliable or ineffective, then transaction testing must be adjusted to increase the amount of coverage. The entry letter identifies the information necessary for the successful execution of the on-site examination procedures.

Scope Memorandum

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that documents specific objectives for the projected examinations. A sample scope memorandum is presented in Appendix I. This document is of key importance, as the scope of the examination will likely vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum will help ensure that the supervisory plan for the institution is executed and will communicate the specific examination objectives to the examination staff.

The scope memorandum should be tailored to the size, complexity, and current rating of the institution subject to review. For large but less complex institutions, the scope memorandum may be combined with the Supervisory Plan or Risk Assessment. The scope memorandum should define the objectives of the examination, and generally should include:

- A statement of the objectives.
- An overview of the activities and risks to be evaluated.
- The level of reliance on internal risk management systems and internal or external audit findings.
- A description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, where appropriate.
• Identification of the procedures that are expected to be performed off-site.

• A description of how the findings of targeted reviews, if any, will be used on the current examination.

**Entry Letter**

It is important that the entry letter be tailored to fit the specific character and profile of the institution to be examined and the scope of the activities to be performed. Thus, the effective use of entry letters is highly dependent upon the planning and scoping of a risk-focused examination. To eliminate duplication and minimize the regulatory burden on an institution, entry letters should not request information that is provided on a regular basis to designated central points of contact or that is available within each Federal Reserve Bank, such as regulatory examination reports and various financial information (e.g., annual reports, Call Reports). Appendix J presents three sample entry letters for: (1) a combined bank holding company and state member bank examination; (2) a bank holding company inspection; and (3) a state member bank examination. These sample letters contain requests for core information that are generally relevant to all institutions, regardless of size or complexity.

When needed in examinations of the larger or more complex organizations, the entry letter should be supplemented by requests for information on specialty activities, such as asset securitization and sales, fiduciary activities, information technology systems, private banking, securities clearance and lending activities, trading activities, and transfer risk. The supplemental specialty examination modules are under development and will be provided at a later date.

As specific items are selected for inclusion in the entry letter, the following guidelines should be considered:

• Reflect risk-focused supervision objectives and the examination scope. Items that are not needed to support selected examination procedures should not be requested.

• Facilitate efficiency in the examination process and lessen the burden on financial institutions. Minimize the number of requested items, and avoid, to the extent possible, duplicating requests for information already provided to other agencies.

• Limit, to the extent possible, requests for special management reports.

• Eliminate items used for audit-type procedures (e.g., verifications). Such procedures are generally performed only when there is a reason to suspect that significant problems exist.
- Distinguish information to be mailed to the examiner-in-charge for off-site examination procedures from information to be held at the institution for on-site procedures. Information that is not easily reproduced should be reviewed on-site (e.g., policies, corporate minutes, audit work papers).

- Allow management sufficient lead time to prepare the requested information.
IX. PERFORMING EXAMINATION PROCEDURES

Examination procedures should be tailored to the characteristics of each institution, keeping in mind size, complexity, and risk profile and should focus on developing appropriate documentation to adequately assess management’s ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. In terms of transaction testing, the volume of loans should be adjusted according to management’s ability to accurately identify problem and potential problem credits and to measure, monitor, and control the institution's exposure to overall credit risk. Likewise, the level of transaction testing for compliance with laws and regulations should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance with applicable laws and regulations.

It is generally expected that most full-scope examinations will include examiners’ evaluation of ten functional areas during the supervisory cycle. However, as the risk-focused supervisory approach is implemented, there may be a need to identify additional functional areas. To evaluate these functional areas, examiners must perform procedures tailored to fit the risk assessment prepared for the institution and the scope memorandum for the examination. These functional areas represent the primary business activities and functions of large complex institutions, as well as common sources of significant risk to them. Further, consistent with the risk-focused approach, examiners are expected to evaluate other areas comprising significant sources of risk to an institution or central to the assignment of CAMELS, BOPEC, and ROCA ratings.

The functional areas currently identified include:

- Loan Portfolio Analysis (portfolio management, loan review, allowance for loan and lease losses)
- Treasury Activities (asset/liability management, interest rate risk, parent company liquidity, funding, investments, deposits)
- Trading and Capital Markets Activities (foreign exchange, commodities, equities, and other interest rate risk, credit risk, and liquidity risk)
- Internal Controls and Audit
- Supervisory Ratings (final assessment of CAMELS, BOPEC, ROCA)
- Information Systems
- Fiduciary Activities
• Private Banking
• Retail Banking Activities (new products and delivery systems)
• Payments System Risk (wire transfers, reserves, settlement)

For each of these ten functional areas, examination modules are being developed that define the review objectives, establish examination procedures, and assist in the documentation of the examination. Where appropriate, modules will be developed in coordination with System experts in specialty areas. Appendix K provides the Internal Controls and Audit Examination Module as a sample module. If a functional area under examination is not covered by one of these modules, the examiner may use the community bank modules or the supervisory manuals to supplement the examination of a complex institution. Appendix L provides a listing of community bank examination modules.

Functional Examination Modules

The modules establish a tiered approach for reviewing the institution’s activities: tier 1 -- Core Decision Factors, tier 2 -- Expanded Analysis, and tier 3 -- Impact Analysis.

**Core Decision Factors** are considered critical to evaluating the functional area under review. A series of procedures are presented under each decision factor that may be considered by examiners in reaching a conclusion on a particular factor. These procedures assist examiners in documenting their conclusions.

**Expanded Analysis** provides a set of procedures that examiners can use when deficiencies or weaknesses are noted during the review of the core decision factors.

**Impact Analysis** requires the examiner to assess the financial impact of identified deficiencies on the institution and possible supervisory actions.

The individual procedures presented for each decision factor are meant only as a guide for completing the modules. Each procedure does not require an individual response and may not always be applicable at every institution. Examiners should continue to exercise discretion in deciding to exclude an item in the evaluation of the core decision factor for a particular institution. Moreover, the procedures do not represent every possible element to be considered during an examination. Accordingly, examiners should refer to the supervisory manuals and supervisory and administrative letters for additional guidance.

The examination modules may be applied to various organizational structures. The core decision factors are applicable to consolidated bank holding companies with state member bank subsidiaries, state nonmember bank subsidiaries, and national bank subsidiaries, as well as branches and agencies of FBOs. However, the manner in which the response to the core decision factor is
obtained differs. In the lending function, for example, one of the core decision factors includes "Is the reserve for loan losses adequate?" For state member banks, detailed procedures would be performed in order to respond to this question. For organizations with a national or state nonmember lead bank, the response may be obtained by reviewing the work of the primary regulator without performing the detailed procedures. In either case, a comprehensive assessment of the consolidated organization must include the answer to this core decision factor.  

**Minimum Documentation Requirements**

It is important for examiners to document their overall conclusions after performing the procedures contained in each module. Conclusions, as each relates to the functional area under review, should clearly communicate the examiner’s assessment of the internal risk management system, the financial condition, and compliance with laws and regulations.

Each module sets forth the core decision factors that should be answered in order to fulfill basic examination objectives for the functional area. Each core decision factor is supported by a listing of procedures that should be considered in order to answer the core decision factor. Although each individual procedure does not require a written response, the answer to each core decision factor must include the examiner’s written rationale in support of the answer.

The examiner’s conclusions may be documented in a separate conclusion memorandum or may be incorporated into the response to the module questions. Documentation should include the procedures performed to address the core decision factors, the conclusions for the area under review, and the findings that should be carried forward into the examination report, or other document used to communicate the findings to the institution’s board of directors and management.

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20 U.S. branches and agencies of FBOs are not required to maintain loan loss reserves. Under the FBO supervision program, the FBO is analyzed with regard to the reliance that can be placed on the FBO’s ability to provide sufficient funds to ensure that its U.S. offices fully honor their contractual obligations.
X. REPORTING THE FINDINGS

Examination activities should be coordinated with the respective state and other federal banking authorities, with joint examinations performed and joint examination reports completed wherever practicable. The examination activities should be planned over the supervisory cycle, culminating with an annual, full-scope examination of the organization. As part of the FBO Supervision Program, individual examination findings are integrated into an assessment of the FBO's entire U.S. operations.

As described previously in Section III - Functional Approach and Targeted Examinations, the results of a targeted, subsidiary, or specialty examination are usually reported to the institution's management in a separate report or supervisory letter. Therefore, the report for the annual full-scope inspection of the consolidated parent organization should include a summary of the relevant results of any preceding supervisory activity. When targeted or specialty examinations of affiliates are conducted concurrently with the annual, full-scope inspection of the consolidated parent organization, the findings from the targeted or specialty examinations should be incorporated into the parent's inspection report in lieu of separate reports, unless the institution's management requests separate reports. For organizations where the lead bank is a state member bank, the annual, full-scope examination report should be combined with the bank holding company inspection report, as appropriate. The bank holding company inspection report, or combined inspection and examination report, may also include other bank and nonbank subsidiary examinations, according to the organization's supervisory plan.

The contents of the report should clearly and concisely communicate to the institution's management or the directorate any supervisory issues, problems, or concerns related to the institution, as well as disclose the assigned supervisory rating.\(^\text{21}\) The report should also include appropriate comments regarding deficiencies noted in the institution’s risk management systems. Accordingly, the descriptions accompanying each component of the CAMELS rating system\(^\text{22}\) should emphasize management’s ability to identify, measure, monitor, and control risks. The rating assigned should reflect the adequacy of the institution’s risk management systems in light of amount and types of risks that the institution has taken on.

\(\text{\textsuperscript{21}}\)Refer to SR letter 96-26 (SUP) for additional information.

\(\text{\textsuperscript{22}}\)Refer to SR letter 96-38 for additional information regarding the revised CAMELS rating system.
APPENDIX A

FEDERAL RESERVE GUIDELINES FOR RATING RISK MANAGEMENT AT STATE MEMBER BANKS AND BANK HOLDING COMPANIES
OVERVIEW

Taking and managing risks are fundamental to the business of banking. Accordingly, the Federal Reserve has always placed significant supervisory emphasis on the adequacy of an institution’s management of risk, including its system of internal controls, when evaluating the management at state member banks and bank holding companies. An institution’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk:

- Credit risk arises from the potential that a borrower or counterparty will fail to perform on an obligation.

- Market risk is the risk to a financial institution’s condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.

- Liquidity risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").

- Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

- Legal risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a banking organization.

- Reputational risk is the 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.

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1These Guidelines were issued as an attachment to SR letter 95-51 (SUP).
These risks and the banking activities associated with them are addressed in greater detail in the Commercial Bank Examination and Bank Holding Company Supervision Manuals, the Trading Activities Manual, and other guidance. In practice, an institution’s business activities present various combinations and concentrations of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for determining a rating for management’s formal or informal systems for identifying, measuring and containing these risks.

ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at state member banks and bank holding companies as part of the evaluation of the overall quality of management, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- active board and senior management oversight;
- adequate policies, procedures, and limits;
- adequate risk measurement, monitoring, and management information systems; and
- comprehensive internal controls

Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk management practices, and not as a checklist of requirements for each institution. Moreover, while all bank holding companies should be able to assess the major risks of the consolidated organization, examiners should expect parent companies that centrally manage the operations and functions of their subsidiary banks to have more comprehensive, detailed, and developed risk management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

Adequate risk management programs can vary considerably in sophistication, depending on the size and complexity of the banking organization and the level of risk that it accepts. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk management systems may be adequate. In such institutions, these systems may consist only of written policies addressing material areas of operations such as lending or investing, basic internal control systems, and a limited set of management and board reports. However, large multinational organizations will require far more elaborate and formal risk management systems in order to address their broader and typically more complex range of financial activities and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. In addition
to the banking organization’s market and credit risks, risk management systems should also encompass the organization’s trust and fiduciary activities, including investment advisory, mutual funds, and securities lending activities.

The risk management processes of large banking organizations would typically contain detailed guidelines that set specific prudential limits on the principal types of risks relevant to their activities worldwide. Furthermore, because of the diversity of their activities and the geographic dispersion of their operations, these institutions will require timely and relatively more sophisticated reporting systems in order to manage their risks properly. These reporting systems, in turn, should comprise an adequate array of reports that provide the levels of detail about risk exposures that are relevant to the duties and responsibilities of individual managers and directors.

Such extensive systems of large institutions will naturally require frequent monitoring and testing by independent control areas and internal, as well as external, auditors to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits. The risk management systems or units of such institutions must also be sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest.

Active Board and Senior Management Oversight

Boards of directors have ultimate responsibility for the level of risk taken by their institutions. Accordingly, they should approve the overall business strategies and significant policies of their organizations, including those related to managing and taking risks, and should also ensure that senior management is fully capable of managing the activities that their institutions conduct. While all boards of directors are responsible for understanding the nature of the risks significant to their organizations and for ensuring that management is taking the steps necessary to identify, measure, monitor, and control these risks, the level of technical knowledge required of directors may vary depending on the particular circumstances at the institution.

Directors of large banking organizations that conduct a broad range of technically complex activities, for example, cannot be expected to understand the full details of their institutions’ activities or the precise ways risks are measured and controlled. They should, however, have a clear understanding of the types of risks to which their institutions are exposed and should receive reports that identify the size and significance of the risks in terms that are meaningful to them. In fulfilling this responsibility, directors should take steps to develop an appropriate understanding of the risks their institutions face, possibly through briefings from auditors and experts external to the organization. Using this knowledge and information, directors should provide clear guidance regarding the level of exposures acceptable to their institutions and have the responsibility to ensure that senior management implements the procedures and controls necessary to comply with adopted policies.
Directors of institutions that conduct more traditional and less complicated business activities may require significantly less knowledge of complex financial transactions or capital markets. They may, however, be more involved in the day-to-day activities and decision-making of their institutions than are their counterparts at larger organizations and should have a level of knowledge commensurate with the nature of their involvement.

Senior management is responsible for implementing strategies in a manner that limits risks associated with each strategy and that ensures compliance with laws and regulations on both a long-term and day-to-day basis. Accordingly, management should be fully involved in the activities of their institutions and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards. Meeting these responsibilities requires senior managers of a bank or bank holding company to have a thorough understanding of banking and financial market activities and detailed knowledge of the activities their institution conducts, including the nature of internal controls necessary to limit the related risks.

In assessing the quality of the oversight by boards of directors and senior management, examiners should consider whether the institution follows policies and practices such as those described below:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities and make appropriate efforts to remain informed about these risks as financial markets, risk management practices, and the institution's activities evolve.

- The board has reviewed and approved appropriate policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary and other significant activities or products.

- The board and management are sufficiently familiar with and are using adequate record keeping and reporting systems to measure and monitor the major sources of risk to the organization.

- The board periodically reviews and approves risk exposure limits to conform with any changes in the institution's strategies, addresses new products, and reacts to changes in market conditions.

- Management ensures that its lines of business are managed and staffed by personnel with knowledge, experience, and expertise consistent with the nature and scope of the banking organization's activities.
Management ensures that the depth of staff resources is sufficient to operate and manage soundly the institution's activities and that its employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.

Management at all levels provides adequate supervision of the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.

Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.

Before embarking on new activities or introducing products new to the institution, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

Adequate Policies, Procedures, and Limits

An institution's directors and senior management should tailor their risk management policies and procedures to the types of risks that arise from the activities the institution conducts. Once the risks are properly identified, the institution’s policies and its more fully articulated procedures provide detailed guidance for the day-to-day implementation of broad business strategies, and generally include limits designed to shield the organization from excessive and imprudent risks. While all banking organizations should have policies and procedures that address their significant activities and risks, the coverage and level of detail embodied in these statements will vary among institutions. A smaller, less complex banking organization that has effective management that is heavily involved in day-to-day operations generally would be expected to have only basic policies addressing the significant areas of operations and setting forth a limited set of requirements and procedures. In a larger institution, where senior managers must rely on widely-dispersed staffs to implement strategies in an extended range of potentially complex businesses, far more detailed policies and related procedures would generally be expected. In either case, however, management is expected to ensure that policies and procedures address the material areas of risk to an institution and that they are modified when necessary to respond to significant changes in the banking organization’s activities or business conditions.

The following guidelines should assist examiners in evaluating the adequacy of a banking organization's policies, procedures, and limits:

The institution’s policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary and other significant activities.
The policies, procedures, and limits are consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.

Policies clearly delineate accountability and lines of authority across the institution's activities.

Policies provide for the review of activities new to the financial institution to ensure that the infrastructures necessary to identify, monitor, and control risks associated with an activity are in place before the activity is initiated.

### Adequate Risk Monitoring and Management Information Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior managers and directors with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization, as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.

The sophistication of risk monitoring and management information systems should be consistent with the complexity and diversity of the institution’s operations. Accordingly, smaller and less complicated banking organizations may require only a limited set of management and board reports to support risk monitoring activities. These reports include, for example, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report for past due loans, a simple interest rate risk report, and similar items. Larger, more complicated institutions, however, would be expected to have much more comprehensive reporting and monitoring systems that allow, for example, for more frequent reporting, tighter monitoring of complex trading activities, and the aggregation of risks on a fully consolidated basis across all business lines and activities. Financial institutions of all sizes are expected to have risk monitoring and management information systems in place that provide directors and senior management with a clear understanding of the banking organization's positions and risk exposures.

In assessing the adequacy of an institution's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether these conditions exist:

- The institution’s risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an on-going basis.
Reports and other forms of communication are consistent with the banking organization’s activities, are structured to monitor exposures and compliance with established limits, goals, or objectives, and as appropriate, compare actual versus expected performance.

Reports to management or to the institution’s directors are accurate and timely and contain sufficient information for decision-makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution.

### Adequate Internal Control

An institution’s internal control structure is critical to the safe and sound functioning of the organization generally and to its risk management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties--such as trading, custodial, and back-office--is one of management’s more important responsibilities.

Indeed, appropriately segregating duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the institution. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting, safeguards assets, and helps to ensure compliance with relevant laws, regulations, and institutional policies. Ideally, internal controls are tested by an independent internal auditor who reports directly either to the institution’s board of directors or its designated committee, which is typically the audit committee. However, smaller institutions whose size and complexity do not warrant a full scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Personnel performing these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management’s responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating the adequacy of a financial institution’s internal controls and audit procedures, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization’s activities.
The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.

Reporting lines provide sufficient independence of the control areas from the business lines and adequate separation of duties throughout the organization--such as those relating to trading, custodial, and back-office activities.

Official organizational structures reflect actual operating practices.

Financial, operational, and regulatory reports are reliable, accurate, and timely; wherever applicable, exceptions are noted and promptly investigated.

Adequate procedures exist for ensuring compliance with applicable laws and regulations.

Internal audit or other control review practices provide for independence and objectivity.

Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high level attention; and management’s actions to address material weaknesses are objectively verified and reviewed.

The institution’s audit committee or board of directors reviews the effectiveness of internal audits and other control review activities on a regular basis.

RATING DEFINITIONS

The rating for risk management is based on a scale of one through five in ascending order of supervisory concern. Examiners should assign this rating to reflect findings within all four elements of sound risk management described above. The risk management rating should be reflected in the overall "Management" rating of the institution and should be consistent with the following criteria:

**Rating 1 (Strong).** A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the institution’s activities, including those from new products and changing market conditions. The board and management are active participants in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions.
Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the institution.

**Rating 2 (Satisfactory).** A rating of 2 indicates that the institution's management of risk is largely effective, but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

**Rating 3 (Fair).** A rating of 3 signifies risk management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management are considered fair, and have precluded the institution from fully addressing a significant risk to its operations. Certain risk management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all significant risks to the institution. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures that could have adverse effects on the institution.

The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the institution if corrective actions are not taken by management.
Rating 4 (Marginal). A rating of 4 represents marginal 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. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management. A number of significant risks to the institution have not been adequately addressed, and the risk management deficiencies warrant a high degree of supervisory attention.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient and management and the board have not demonstrated the capability to address deficiencies.

Internal controls may be sufficiently weak as to jeopardize seriously the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the institution's risk management procedures and internal controls require immediate and close supervisory attention.

REPORTING CONCLUSIONS

For state member banks, a single numerical rating for risk management and the rationale for the rating assigned should be provided on page D, "Ratings and General Information," of the confidential section of the bank examination report. The risk management rating should also be an important factor when determining the overall management rating of the CAMEL rating system. Comments, conclusions, and criticisms relating to a bank's risk management process should be brought to the attention of management and included on the "Management/ Administration" page of the report, as well as pages 1 and 1a, "Examination Conclusions and Comments" and "Matters Requiring Board Attention" if considered appropriate. Comments in the close-out meeting with management and in the open sections of the examination report, in sufficient detail to bring about proper corrective actions, are particularly important if the examiner has assigned risk management a rating that is less than satisfactory.
Examiners should also consider the extent to which weaknesses in a bank's management of risk may indicate material noncompliance with one or more safety and soundness guidelines covering internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth or compensation, fees, and benefits.\(^2\) Organizational procedures directing and enforcing an adequate separation of duties can be especially critical to some banking activities, such as so-called "front" and "back-office" functions, and should be specifically addressed by examiners. In instances in which material noncompliance is identified, authority exists to require the state member bank to submit a compliance plan within 30 days if such weaknesses are not being adequately addressed through other means.

For bank holding companies, the separate numerical rating for risk management, and the rationale for the rating assigned, should be included and discussed on page B, "Condition of Bank Holding Company," of the confidential section of the bank holding company inspection report, and should also be reflected in the examiner's overall rating of management. Comments, conclusions, and criticisms relating to an institution's risk management process should be brought to the attention of management and included on the "Policies and Supervision" page of the inspection report, as well as on page 1, "Examination Conclusions and Matters Requiring Special Board Attention" if considered appropriate and particularly if the rating is less than satisfactory.

In reports of examination or inspection and in transmittal letters to boards of directors of state member banks and bank holding companies reference should be made specifically to the types and nature of corrective actions that need to be taken by institutions to address noted risk management and internal control deficiencies. Where appropriate, institutions should also be advised that the Federal Reserve will initiate supervisory actions if the failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of their activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank or bank holding company, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

\(^2\)These guidelines are included in Subpart D (Standards for Safety and Soundness) of the Board’s Regulation H and became effective August 9, 1995.
APPENDIX B

NONBANK SUBSIDIARY
OF A BANK HOLDING COMPANY
RISK ASSESSMENT QUESTIONNAIRE
NONBANK SUBSIDIARY OF A BANK HOLDING COMPANY
RISK ASSESSMENT QUESTIONNAIRE

Name of Subsidiary ________________________________

Name of Bank Holding Company ___________________________

BHC Consolidated:
Tier 1 Capital: $___________ Total Operating Revenue*: $ _____________
*Defined as the sum of total interest income and total noninterest income, before extraordinary items.

Subsidiary Total Assets: $_________ Subsidiary Total Operating Revenue: $ _________

Questions:
1. Are the Subsidiary’s total assets 10% or more of BHC consolidated Tier 1 capital? Yes No

2. Are the Subsidiary’s total operating revenue 10% or more of BHC consolidated operating revenue? Yes No

3. Does the Subsidiary issue debt to unaffiliated parties? Yes No

4. Does the Subsidiary rely upon affiliated banks for funding, greater than $10 million or 5% of BHC consolidated Tier 1 capital? Yes No

5. Is the Subsidiary involved in asset securitization? Yes No

6. Does the Subsidiary generate assets and sell assets to affiliates? Yes No

7. Is the Subsidiary a Section 20 company? Yes No

8. Does the Subsidiary provide derivative instruments for sale or as a service to unaffiliated parties? Yes No

9. Has the Subsidiary had a significant impact on the BHC’s condition or performance? Yes No

If any question is answered yes, then this subsidiary should be considered for on-site review. If an on-site review is not being conducted, state reason below.

Prepared By: ______________________ Date: ___________
APPENDIX C

GENERAL EXAMINATION
FREQUENCY SCHEDULE
## GENERAL EXAMINATION/INSPECTION SCHEDULE FOR BANKING ORGANIZATIONS

**PRIMARILY SUPERVISED BY THE FEDERAL RESERVE**

(June 5, 1997)

<table>
<thead>
<tr>
<th>FREQUENCY</th>
<th>LARGE INSTITUTION</th>
<th>SMALL INSTITUTION</th>
<th>STATUTORY GUIDELINES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State Member Banks and Their Subsidiaries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Safety and Soundness</td>
<td>Full Scope</td>
<td>Full Scope</td>
<td>S</td>
</tr>
<tr>
<td>II. Fiduciary</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Trust</td>
<td>Full Scope &amp;/or Target</td>
<td>1 - 2 years</td>
<td>2 years</td>
</tr>
<tr>
<td>b. Transfer Agent</td>
<td>6 mos. - 2 years</td>
<td>6 mos. - 3 years</td>
<td>G</td>
</tr>
<tr>
<td>c. Registered Clearing Agent</td>
<td>6 mos. - 1 year</td>
<td>6 mos. - 1 year</td>
<td>G</td>
</tr>
<tr>
<td>d. Investment Advisers</td>
<td>Concurrent with Trust/SMB</td>
<td></td>
<td>G</td>
</tr>
<tr>
<td>III. Information Systems</td>
<td>Full Scope &amp;/or Target</td>
<td>1 - 2 years</td>
<td>2 years</td>
</tr>
<tr>
<td>IV. Securities Activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Municipal Securities Dealers</td>
<td>2 years</td>
<td>2 years</td>
<td>S</td>
</tr>
<tr>
<td>b. Compliance Examinations for Lending Secured by Margin Stock (Reg G)</td>
<td>2 years</td>
<td>2 years</td>
<td>G</td>
</tr>
<tr>
<td>c. U.S. Government Securities Dealers</td>
<td>1 - 2 years</td>
<td>1 - 2 years</td>
<td>G</td>
</tr>
<tr>
<td>V. Bank Secrecy Act</td>
<td>Annual</td>
<td>Annual</td>
<td>G</td>
</tr>
<tr>
<td><strong>Edge Act and Agreement Corporations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Domestic Edge Act and Agreement Corporations (Reg K)</td>
<td>Annual</td>
<td>Annual</td>
<td>S</td>
</tr>
<tr>
<td>b. Branches of Domestic Edge Act and Agreement Corporations</td>
<td>2 years</td>
<td>3 years</td>
<td>G</td>
</tr>
<tr>
<td>c. Foreign Subsidiaries of Edge Act and Agreement Corporations</td>
<td>2 years</td>
<td>3 years</td>
<td>G</td>
</tr>
<tr>
<td><strong>Bank Holding Companies and Their Non-Bank Subsidiaries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Safety and Soundness</td>
<td>Full Scope</td>
<td>Full Scope &amp;/or Target</td>
<td>1 - 3 years</td>
</tr>
<tr>
<td>II. Non-Bank Subsidiaries</td>
<td>Annual</td>
<td>Yearly, if risky</td>
<td>G</td>
</tr>
<tr>
<td>III. Section 20 Subsidiaries</td>
<td>Annual</td>
<td>Annual</td>
<td>G</td>
</tr>
<tr>
<td><strong>U.S. Branches and Agencies of Foreign Banking Organizations</strong></td>
<td>Full Scope</td>
<td>Full Scope</td>
<td>12 - 18 mos.</td>
</tr>
</tbody>
</table>

1Except for statutorily mandated examinations, these frequency guidelines generally apply to those operations that are material to the consolidated organization and are in sound financial condition.
APPENDIX D

INSTITUTIONAL OVERVIEW
INSTITUTIONAL OVERVIEW

As of 9/30/96

First Bancorp, Inc.  Responsible F.A. (FDIC): San Francisco
Las Vegas, Nevada  Portfolio Manager: Bob Smith
Total Assets: $20 Billion  Phone: (415) 555-1249
BOPEC: 2-2-2-2-2/2S, (06/30/96)  Date Prepared: 12/12/96

Overall Condition

Supervisory concern related to First Bancorp, Inc. (First Bancorp) is moderate. The company is engaged in a program of expansion and is characterized by having increasing levels of operational, credit and liquidity concerns. Management is contemplating additional acquisitions, product expansion and broadening the fee revenue side of the business. To the positive, the company employs a satisfactory risk management system, augmented by adequate policies, procedures and internal controls. Management and the board have effectively guided the institution through a recent economic downturn, and they have deployed strategies to address the short and long term needs of the company. The company’s financial performance remains satisfactory.

Structure

First Bancorp is the largest financial institution in the State of Nevada and ranks as one of the top 50 Bank Holding Companies (BHCs) in the U.S. The company provides financial services to customers throughout Nevada and Utah. Its principal subsidiaries are the Bank of Nevada and Bancorp Nevada, Inc. (formerly FirstFed Nevada, Inc., a savings and loan holding company). These two subsidiaries represent 90% and 8% of consolidated assets, respectively. First Bancorp also owns First National Bank of Utah (1.5%) and three active nonbanking companies (less than 1%) engaged in mortgage, small business investment, and lending operations.

Market Indicators:

<table>
<thead>
<tr>
<th>Standard &amp; Poor’s</th>
<th>Moody’s Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Paper</td>
<td>A2</td>
</tr>
</tbody>
</table>

| Market/book @ 09/30/96 | 182%                |
| High/Low/Close @ 09/30/96 | 55.00/39.50/52.00 |

Key Issues

<table>
<thead>
<tr>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
<th>Direction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operational</td>
<td>X</td>
<td>Increasing</td>
<td></td>
</tr>
<tr>
<td>Credit</td>
<td>X</td>
<td>Increasing</td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td>X</td>
<td>Increasing</td>
<td></td>
</tr>
<tr>
<td>Market</td>
<td>X</td>
<td>Decreasing</td>
<td></td>
</tr>
<tr>
<td>Legal</td>
<td>X</td>
<td>Stable</td>
<td></td>
</tr>
<tr>
<td>Reputational</td>
<td>X</td>
<td>Stable</td>
<td></td>
</tr>
</tbody>
</table>

1An Institutional Overview would be classified as a "Restricted F.R." document.
Most of the key issues relate to First Bancorp’s strategy of ongoing growth in Nevada and Utah. The following items are driving the risks at Bancorp:

**Operational Risk**

- Ability to implement and maintain adequate internal controls given the company’s continual expansion.
- Integration of systems and the resultant ability of the management information systems (MIS) process to capture risks on a consolidated basis.
- Nominal due diligence conducted prior to acquiring majority ownership interests in two banks.
- Ability to convert the systems of acquired entities given that the company has not formalized a methodology for this process.

**Credit Risk**

- Recent increases in nonperforming assets.
- Effect on classification levels when integrating portfolios of the two acquired banks.

**Liquidity Risk**

- Continued reliance on foreign deposits as a significant funding source.
- Ability to attract desired levels of core deposits.

**Strategic Initiatives**

Management has taken steps to focus on lines of business with greater marginal profitability and scaling back those businesses that do not offer adequate returns. The company has also transitioned to more of a performance-based culture, which has prompted a narrowing of managerial reporting lines, a greater emphasis on incentive based compensation, an adherence to customer profitability tracking and hurdle rates, and an increased emphasis on efficiency and productivity. Bancorp is the dominant banking presence in the State of Nevada, with a 35 percent deposit market share, the largest ATM network in the state, and a leading position in residential mortgage lending. This dominance has strengthened during Nevada’s economic expansion.

The company has already built significant shares in most local lines of business. Accordingly, management continues to seek diversification, as well as expansion, through acquisition of banking companies located outside of Nevada. To date, these acquisitions have included
companies in neighboring states, although management is not limiting the company's geographical expansion. Furthermore, the acquisitions have functioned as a source of liquidity because the company has been affected by disintermediation.

**Corporate Profile**

The company provides retail and commercial banking services. Lending activities are focused on small and middle-market businesses in First Bancorp's local markets, larger corporate clients, and loans secured by real estate properties. Nevada-based credit accounts for approximately 65 percent of all loans. The company is scaling back its efforts in large corporate lending, given the low returns, and will focus its larger lending relationships on industry specializations, including media and communications, as well as health care. On the retail side of the business, the company has increased its mortgage banking and credit card operations.

Fee revenue is modest in relation to the company's total income stream, but targeted for expansion. To date, the company generates stable sources of fee revenue from its ATM network, which draws over 50 percent of its volume from non-First Bancorp customers, and from its role as a clearing and settlement bank for over 50 local institutions. While these fee sources have generated a steady income stream, the company recognizes that it needs to continue to broaden its revenue sources. To this end, it has invested heavily in developing its trust business ($15 million in assets under management) and developed a number of life-cycle products featuring mutual funds ($5 million in assets under management). In the future, the company desires to acquire an investment adviser and insurance agencies.

**Management Overview**

Management oversight of First Bancorp is effected through the Office of the Chairman, consisting of Chairman Carolyn Browne, 56; and three vice chairman: Thomas White, 58; Diana Smith, 47; and A.J. Miles, 51. Ms. Brown has been a long time employee of the company and remains the key decision-maker for the company. Mr. White has responsibility for the company's retail banking sector, Ms. Smith heads the corporate banking and investments sector, and Mr. Miles has the responsibility for the company's trust sector.

The risk management process is primarily managed through the operating committees of the Bank of Nevada; however, there are severeral critical individuals linked to this process. Executive Vice President Donald Crankshaw is the company's ultimate risk management officer, with senior officers responsible for risk management reporting to him. Mr. Crankshaw reports directly to Ms. Browne. Risk management has been broken down into five functional areas: Credit; Market; Middle Market; Consumer; and Fiduciary. Operational risk is managed through Auditing, which is headed by Senior Vice President William Lee, and the Informations Systems area, headed by the newly hired Chief Information Officer, Monica Terrell. Interest rate risk, liquidity and funding
are managed on a consolidated basis by the company’s Treasury Department reporting to Chief Financial Officer Dan Cortez.

Financial Overview

First Bancorp has a record of long-term earnings growth and solid financial performance strengthened by Nevada’s booming economy. Growth prospects are becoming increasingly tied, but not limited, to activity in the Las Vegas and southern Utah areas.

Earnings

FBI’s overall condition remains satisfactory, a reflection primarily of the condition of Bank of Nevada. Earnings for the third quarter of 1996 were satisfactory despite a modest decline due to a nonrecurring charge related to the Savings Association Insurance Fund (SAIF) recapitalization. Year-to-date earnings increased over the same period in 1995.

Asset Quality

Although classified assets decreased over the quarter, nonperforming assets increased to $123 million at September 30, 1996, due to nonperforming assets acquired from the new banks. Loan loss reserves appeared adequate; however, the coverage of nonaccrual loans has been trending downward since last year.

Capital

Capital remains adequate with third quarter capital ratios relatively unchanged from the prior quarter, and remaining above "well-capitalized" thresholds.

<table>
<thead>
<tr>
<th>Consolidated Financial Overview</th>
<th>1994</th>
<th>1995</th>
<th>9/30/96</th>
<th>Peer</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROAA</td>
<td>0.89</td>
<td>0.94</td>
<td>0.90</td>
<td>1.24</td>
</tr>
<tr>
<td>NPA/Loans + OREO</td>
<td>0.73</td>
<td>0.75</td>
<td>1.23</td>
<td>0.85</td>
</tr>
<tr>
<td>ALL/Loans</td>
<td>1.90</td>
<td>1.90</td>
<td>2.10</td>
<td>1.99</td>
</tr>
<tr>
<td>Tier 1 Capital Ratio</td>
<td>10.20</td>
<td>10.10</td>
<td>9.70</td>
<td>9.39</td>
</tr>
<tr>
<td>Dividend Payout</td>
<td>33.60</td>
<td>33.40</td>
<td>33.00</td>
<td>41.60</td>
</tr>
<tr>
<td>Double Leverage</td>
<td>99.90</td>
<td>101.00</td>
<td>101.00</td>
<td>107.20</td>
</tr>
<tr>
<td>Asset Growth</td>
<td>1.00</td>
<td>6.00</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Nevada’s Economy
The state’s main industry, tourism, has shown steady improvement. Economists expect 1996 to be a record year for visitors and expenditures. Visitor arrivals through September 1996 totaled 15 million, up by 20% from the same period last year.

<table>
<thead>
<tr>
<th>Regulatory Ratings</th>
<th>DATE</th>
<th>CAMEL</th>
<th>&amp; CRA</th>
<th>TRUST</th>
<th>IS</th>
<th>CAMEO</th>
<th>AGENCY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Nevada</td>
<td>06/30/96</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>FDIC</td>
</tr>
<tr>
<td>FNB Utah</td>
<td>05/01/96</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>OCC</td>
</tr>
<tr>
<td>1st Fed Nevada</td>
<td>06/30/96</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>OTS</td>
</tr>
<tr>
<td>Fed Savings (Wadsworth)</td>
<td>12/31/95</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>OTS</td>
</tr>
</tbody>
</table>
APPENDIX E

RISK MATRIX
### INSTITUTIONAL RISK MATRIX
**A Risk Assessment Tool**

First Bancorp, Inc.  
Las Vegas, NV  
Portfolio Manager: Bob Smith  
Date Prepared: 12/12/96

<table>
<thead>
<tr>
<th>Functional Activities</th>
<th>Volume or Relative Weight</th>
<th>Inherent Risks</th>
<th>Risk Management Systems</th>
<th>Composite</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Credit</td>
<td>Market</td>
<td>Liquidity</td>
</tr>
<tr>
<td>Lending</td>
<td></td>
<td>MOD</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Commercial</td>
<td>10% TA</td>
<td>MOD</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Real Estate</td>
<td>30% MED 50%</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Personal</td>
<td>45% MOD 25%</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Lease</td>
<td>15% MOD 15%</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Other</td>
<td>8% MOD 8%</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>CRE/ED</td>
<td>2% MOD 2%</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Treasury and Investments</td>
<td>Low - 25% TA</td>
<td>LOW</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Swaps</td>
<td>Low</td>
<td>LOW</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Trading Leases</td>
<td>Low</td>
<td>MOD</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Retail Operations</td>
<td>MOD</td>
<td>LOW</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Deposit and</td>
<td>MOD 30% foreign dep.</td>
<td>MOD</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Investment Products</td>
<td>Low - CP 2% of TA</td>
<td>MOD</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Payments System</td>
<td>MOD</td>
<td>LOW</td>
<td>MOD</td>
<td>LOW</td>
</tr>
<tr>
<td>Information Systems</td>
<td>HIGH</td>
<td>LOW</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Systems</td>
<td></td>
<td>LOW</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Mergers and</td>
<td>HIGH</td>
<td>MOD</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Acquisitions</td>
<td></td>
<td>MOD</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Trust</td>
<td>LOW</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Human Resources</td>
<td>LOW</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Legal</td>
<td>LOW</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>New Technology</td>
<td>HIGH</td>
<td>LOW</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>Audit Services</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
<td>MOD</td>
</tr>
<tr>
<td>CRA</td>
<td>LOW</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>Insurance Sales</td>
<td>LOW</td>
<td>LOW</td>
<td>LOW</td>
<td>MOD</td>
</tr>
<tr>
<td>OVERALL COMPOSITE RISK</td>
<td></td>
<td></td>
<td>MOD</td>
<td>MOD</td>
</tr>
</tbody>
</table>

*A Risk Matrix would be classified as a "Restricted F.R." document.*
APPENDIX F

RISK ASSESSMENT
RISK ASSESSMENT

First Bancorp, Inc. 
Las Vegas, Nevada 
Total Assets: $20 Billion 
BOPEC: 2-2-2-2-2/2S, (06/30/96)

Responsible F.A. (FDIC): San Francisco 
Portfolio Manager: Bob Smith 
Phone: (415) 555-1249 
Date Prepared: 12/12/96

Internal Risk Assessment System

First Bancorp, Inc. (First Bancorp) employs a satisfactory risk management system. On a consolidated basis, risk is primarily managed through the operating committees of Bank of Nevada, which represents roughly 90 percent of consolidated assets. Management of risk is further decentralized between departments and committees within Bank of Nevada. Areas of moderate risk include operational, credit, market, and liquidity. The moderate level of risk is primarily associated with the company’s future ability to maintain adequate internal controls, a meaningful management information systems (MIS) process, and appropriate due diligence associated with its recent and proposed acquisitions. Legal and reputational risk are considered low risk areas and are monitored and managed on an appropriate ad hoc basis.

Overall, policies, procedures, and internal controls are generally satisfactory. Each subsidiary maintains written guidelines covering the six areas of risk. These guidelines are reviewed and revised regularly. No significant adverse comments were noted in reports issued by the primary regulators of the insured subsidiaries. In addition, the current internal controls are satisfactory based on the institution’s FDICIA 112 self-assessment, and the lack of significant criticism from internal and external audit reports, evaluations by outside consultants, and regulatory reviews.

Overall Assessment

Overall Risk Rating: Moderate  Direction: Increasing  Date of Review: 9/30/96  Date Updated: 12/5/96

The company is in satisfactory financial condition and conducts its business in a sound manner. Management has demonstrated effective leadership in guiding the institution through recent acquisitions, diversification of product lines and revenue sources, and emphasizing profitable business lines, while scaling back unprofitable business lines. Also, the institution has enjoyed satisfactory asset quality, earnings, and liquidity in recent years.

The company’s risk trend, though, is increasing. The institution has engaged in a program of expansion, and is experiencing operational difficulties in managing the merger of information systems, an increasing level of problem loans, and an increased reliance on foreign deposits at the expense of lower-cost core deposits.

1A Risk Assessment would be classified as a "Restricted F.R." document.
Operational Risk

Operational Risk Rating: *Moderate* Direction: *Increasing*  Date of Review: 9/30/96  Date Updated: 12/5/96

Operational Risk Rating - Operational risk is moderate; however, the level of risk is increasing. The increasing level of operational risk is associated with the company’s expansion in Nevada and Utah, and the company’s ability to maintain and implement adequate internal controls and MIS. In addition, the company’s due diligence process for proposed acquisitions needs to be enhanced. Other areas of operational risk, such as the audit function, appear adequate at this time.

Internal controls are adequate; however, the company is continually challenged to maintain these controls in light of the recent and proposed expansion in Nevada and Utah. Future problems could surface because of the lack of in-depth due diligence performed in the acquisition of two banks in May 1996, totalling $1 billion in assets. In addition, First Bancorp has not developed a formal methodology or procedure to convert and integrate an acquiree’s systems prior to the bank’s acquisition. Although the company obtains systems information about the institution to be acquired, management has not effectively used this information to develop a plan of action. Systems from prior acquisitions have been integrated without incident, but this may not be the case for future acquisitions and mergers. The FDIC recommended that management enhance its due diligence procedures prior to an acquisition.

Operational Risk Management - The company adequately identifies and monitors risk. The audit program includes an annual assessment of its internal control environment in compliance with FDICIA 112. The program includes a comprehensive evaluation of corporate division risks and established controls. The internal audit department is involved in reviewing new product lines and information systems (IS) prior to conversion. All major operating areas of the organization have been audited over the last twelve months and no significant weaknesses have been disclosed. Furthermore, over the last several examinations and inspections no significant operating weaknesses have been noted with the exception of interest rate risk management in 1994. The institution employs an satisfactory disaster recovery program and maintains an adequate insurance program.

Management Information Systems

Management information systems are adequate; however, the company’s expansion presents challenges in ensuring that systems are adequately integrated and in turn accurately reflecting the company’s condition on a consolidated basis. The MIS review conducted during the June 30, 1996 joint inspection disclosed significant manual intervention within the systems. These concerns are associated with the information contained on the organization’s loan trial balance and the systems used by the newly acquired entities. The majority of the stand-alone operations are not integrated into the consolidated general ledger control system. This integration process
requires manual intervention which increases the potential for inaccurate reports. The company’s MIS needs to incorporate automated assimilation of information from the stand alone branches to ensure the accuracy of consolidated reports.

**Internal Audit Function**

The effectiveness of the internal audit function has historically been and continues to be rated satisfactory. The audit and credit review departments provide corporate-wide coverage. A corporate executive officer is dedicated exclusively to the supervision of the audit and credit review function with a direct reporting line to the board’s audit committee. The audit program is reviewed and approved annually by the audit committee, which is composed entirely of qualified outside directors. Report findings receive appropriate attention, including follow-up responses to exceptions and weaknesses.

The organization employs a fully integrated audit system which includes significant participation in internal audits by the external auditors. External auditors are responsible for branch audits and augmenting the internal staff to fulfill the annual audit plan. Internal audit workpapers document appropriate reviews of internal controls within each operating area of the corporation. The June 30, 1996 inspection report suggested that improvements were needed in the presentation of certain summary information to the audit committee and that some policies and practices should be strengthened to enhance management of operational risks.

**Credit Risk**

<table>
<thead>
<tr>
<th>Credit Risk Rating</th>
<th>Direction</th>
<th>Date of Review</th>
<th>Date Updated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderate</td>
<td>Increasing</td>
<td>9/30/96</td>
<td>12/5/96</td>
</tr>
</tbody>
</table>

Credit Risk Rating - Credit risk is moderate; however, the company’s level of credit risk is increasing. The moderate rating is supported by the company’s historically satisfactory asset quality ratings, improving classification ratios, satisfactory credit administration, and adequate risk identification. The increasing level of credit risk, as reflected in quarterly company-prepared credit risk reports, is associated with the classification ratios not incorporating the assets of recent acquisitions and a slight increase in the level of nonperforming assets. Although classification ratios are improving, the ratios do not include the classified assets of the newly acquired banks since these were not reviewed by either the FDIC or the company’s internal loan review department. In addition, nonperforming assets were on the rise during the third quarter of 1996. The organization has three significant areas which have inherent credit risk: lending, investment, and hedging activities. First Bancorp does engage in trading activities; however, these activities have no material effect on the organization.
Lending

Asset quality remains satisfactory; however, the classification ratios do not include potential problem assets from the newly acquired entities nor factor in the increasing levels of nonperforming assets. As of September 30, 1996, consolidated total and weighted classification ratios were 42.1 percent and 9.8 percent respectively, a decrease from prior quarter levels and the first decrease since the end of 1995. However, classifications do not include potential problem assets from the newly acquired banks, which substantially increased the size of the commercial and industrial portfolio. In addition, nonperforming loans rose to 1.8 percent of total loans, compared to 1.1 percent at the end of the second quarter of 1996. Although loan loss reserves appeared adequate as of September 30, 1996, the coverage of nonaccrual loans has been trending downward since last year. Loan loss reserves declined from 310 percent of nonaccruals as of September 30, 1995, to 173 percent as of September 30, 1996. Source: FRB 9/30 Quarterly Review.

Loan Portfolio Diversification - First Bancorp’s loan portfolio is composed as follows:

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate secured transactions</td>
<td>45.0%</td>
</tr>
<tr>
<td>Commercial &amp; industrial loans</td>
<td>30.0%</td>
</tr>
<tr>
<td>Personal loans</td>
<td>15.0%</td>
</tr>
<tr>
<td>Lease financing</td>
<td>8.0%</td>
</tr>
<tr>
<td>Other</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

The real estate loan portfolio is composed primarily of loans secured by single family dwellings representing 63.1 percent of total real estate loans. Approximately 97 percent of the real estate loans were underwritten on a floating basis. The commercial loan portfolio predominantly includes commercial business, financial, and agricultural enterprises. Commercial loans almost doubled from year-end 1995 as a result of the purchases of the Winnemucca and Carson City banks. Source: 9/96 10Q Report

Loan Portfolio Management - Credit administration and overall credit risk management is satisfactory. Review of the credit administration function at the insured subsidiaries found underwriting guidelines conservative and the process competently managed. The FDIC found the Bank of Nevada’s loan grading system to be satisfactory at its 6/96 examination. Satisfactory credit risk management is accomplished through:

- board-approved credit policies and standards
- recurring portfolio quality reviews
- established loan officer authorization limits
- concentration limits
- monthly reports covering trends in classified assets and problem loans
- quarterly analyses of reserve adequacy
- an effective system for identifying and grading risk assets
Investments

Overall management of the investment portfolio has historically been satisfactory. First Bancorp’s investment portfolio totaled $4.3 billion, with 25 percent held-to-maturity and 75 percent available-for-sale as of September 30, 1996. Investments are primarily composed of U.S. government and agency issues. Source: 9/96 10Q Report.

*Investment Portfolio Management* - The board has established reasonable guidelines that include limits by type and quality. The investment portfolio is supervised through management’s Asset and Liability Committee (ALCO), which reports monthly to the board of directors.

Derivative Products (see also Market Risk)

The institution has limited credit exposure via its portfolio of interest rate swaps. Credit risk arises from the potential of counterparties not performing on the contract while market risk is associated with movement in interest rates. Hedging instruments utilized by the organization primarily include swap agreements. As of September 30, 1996, the notional value of derivative contracts was approximately $1.2 billion in interest rate swap contracts. First Bancorp calculated its credit exposure from swaps at approximately $3.5 million at year-end 1995. Source: 9/96 10Q Report.

*Derivative Management* - First Bancorp controls this credit risk through an established credit approval process, limits, and monitoring procedures. The organization has established limits on the notional amount of outstanding contracts and counter party balances.

Trading Securities

The organization is not focused on actively generating trading revenue. As of September 30, 1996, the organization reported outstanding trading assets of $1.4 million. The organization conducts trading activity primarily through its lead bank, Bank of Nevada.

*Trading Risk Management* - Trading is governed by satisfactory policy guidelines which define eligible securities, trading position types, and trading limits. The policy also addresses safekeeping and deliveries, maximum holding periods for securities traded, monthly pricing requirements, and provisions for exceptions and amendments.
**Liquidity Risk**

**Liquidity Risk Rating**: Moderate  
**Direction**: Increasing  
**Date of Review**: 9/30/96  
**Date Updated**: 12/5/96

*Liquidity Risk Rating* - Liquidity risk is moderate; however, the level of liquidity risk is increasing. The increasing exposure is associated with the company’s continued reliance on foreign deposits and a below-budget level of core deposits. Excluding these two issues, the company’s liquidity is adequate and based on effective policies and procedures. In addition, the company has sufficient secondary funding sources and appropriate board and management oversight.

The company continues to rely on a significant level of foreign deposits to fund activities. These deposits have proven to be stable. Foreign deposits represent 30 percent of the company’s total deposits at September 30, 1996, increasing from 26 percent at December 31, 1995. The increase is primarily associated with the acquisition of the Winnemucca and Carson City Banks. Consolidated deposits increased slightly from $7 billion at year-end 1995 to $7.9 billion at September 30, 1996, reflecting the second quarter bank acquisitions which included $0.9 billion in deposits. In addition to the foreign deposits, the company maintains a high level of state and local government funds. Public deposits have historically been a stable source of funds at First Bancorp.

Strong competition for deposits, not only from banks and savings and loans, but also from securities brokerage firms, continues to impact the company’s ability to attract desired levels of core deposits. Despite intense competition, the company continues its efforts to increase its level of core deposits. During the third quarter, the Bancorp completed an acquisition of 4,500 deposit accounts from Reno Credit Corporation, which increased core deposits by $45 million. In an effort to expand its presence in Utah, First Bancorp’s Utah bank subsidiary signed a definitive agreement to acquire four branches of American Bank Utah with deposits of approximately $270 million. This transaction is expected to close during the first quarter of 1997.

The institution issues commercial paper exclusively to accredited local investors. The program is limited to customers and is therefore not advertised. Commercial paper proceeds are invested in overnight deposits at Bank of Nevada. As of September 30, 1996, commercial paper outstanding totaled $412 million. These short-term notes are rated A-2 by Standard and Poor’s and P-1 by Moody’s. Furthermore, First Bancorp has successfully negotiated private placements to replace maturing, adding flexibility to liquidity management.

*Liquidity Risk Management* - Management of liquidity is satisfactory as evidenced by appropriate board and management oversight, adequate policies and procedures, comprehensive MIS reports, and effective controls. Liquidity risk is managed on a consolidated basis under the Bank of
Framework for Risk-Focused Supervision of Large Complex Institutions

August 8, 1997

HYPOTHETICAL EXAMPLE

Nevada’s Treasury Department through the ALCO. Comprehensive liquidity planning and written policies properly support management decisions. Liquidity and funds management policy incorporates limitation on risk exposures based on several standard liquidity ratios. Reporting systems provide pertinent management information, assisting the board to oversee the bank’s liquidity position. Sound controls have minimized risk exposures. Furthermore, the corporation has engaged the services of outside professionals to review its funds management, reporting structure, and internal controls. Consultant findings were reviewed by management and the board, and appropriate corrective action was implemented.

Market Risk

Market Risk Rating: Moderate   Direction: Decreasing   Date of Review: 9/30/96   Date Updated: 12/5/96

*Market Risk Rating* - Market risk is moderate and decreasing. This assessment primarily reflects the complexity of the institution’s balance sheet and off-balance sheet instruments utilized to mitigate market risk. In addition, the company developed appropriate tools to measure and monitor interest rate risk. As previously mentioned under credit risk, derivative products have been utilized primarily for hedging purposes and the institution has not been an active securities trader.

The organization, primarily through Bank of Nevada, purchased interest rate swaps in late 1993 and early 1994. Interest rate swaps were acquired to hedge against interest rate risk and reached a high notional balance of $2 billion at year-end 1994. The bank originally engaged in these transactions without appropriate controls or expertise. The net effect of these swaps was an increase in the bank’s liability-sensitive position, causing the net interest margin to contract; by contrast, most banks enjoyed a comfortable expansion resulting from rising rates in 1994. The bank has strengthened its management of hedging activities since entering into these transactions. Although the net paying position caused by these swap transactions continues to adversely impact the net interest margin, the bank has no plans to neutralize these positions due to the excessive penalty fees associated with early termination. The swaps will continue to amortize down from their present balance of $1.2 billion; the average weighted maturity of these instruments is less than three years. No hedging activities have been undertaken since early 1994, and swaps are expiring without replacement. Furthermore, management has no plans to engage in hedging activities in the future. As of September 30, 1996, the consolidated organization’s one-year cumulative sensitivity gap was asset sensitive and totalled $0.5 billion compared with a year-end 1995 liability sensitive position of $0.3 billion. Source: 9/96 10Q Report.

*Market Risk Management* - The organization has developed appropriate tools to measure and monitor interest rate risk. Interest rate risk management model enhancements are in the process
of implementation in accordance with recommendations made by outside consultants and regulatory agencies. Current model outputs exhibit a risk profile within board of director established limits. Market risk is managed through:

- board approved policies
- management reports reflecting current position and limits
- periodic review of process and control
- monthly reporting through ALCO
- simulation modeling for interest rate sensitivity

**Legal Risk**

<table>
<thead>
<tr>
<th>Legal Risk Rating: Low</th>
<th>Direction: Stable</th>
<th>Date of Review: 6/30/96</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Date Updated: 9/30/96</td>
</tr>
</tbody>
</table>

*Legal Risk Rating* - Legal risk is low and considered stable. The low level of legal risk is due to management’s adequate monitoring of procedures and subsequent low number of violations.

First Bancorp has experienced a relatively low number of violations of law over the preceding year; regulatory reports have cited only one inadvertent violation of law over the prior twelve months. The organization maintains adequate insurance coverage for all functional areas. The organization’s compliance with consumer laws and regulations, as well as the Community Reinvestment Act (CRA), is satisfactory. In addition, fiduciary operations are sound.

*Legal Risk Management* - Legal risk is managed on an integrated basis with the legal department providing consultation to all levels of management on a broad spectrum of issues. Although First Bancorp’s management process for legal risk is not formally outlined in written policies, the system provides adequate protection and monitoring reports to senior management and the board. These reports summarize pertinent information concerning all outstanding litigation, including potential liability. Legal risk is managed through:

- an effective compliance program
- monitoring of lender liability, human resources, operations and new products
- reports to subsidiary boards of directors
- quarterly reporting and semi-annual review by the corporate audit committee

**Reputational Risk**

<table>
<thead>
<tr>
<th>Reputational Risk Rating: Low</th>
<th>Direction: Stable</th>
<th>Date of Review: 9/30/96</th>
</tr>
</thead>
</table>


Reputational Risk Rating - Reputational risk is low and remains stable. The low level of reputational risk is associated with management’s ad-hoc marketing monitoring procedures. In addition, the company has maintained adequate consumer compliance ratings and strong debt ratings.

The organization’s compliance with consumer laws and CRA has been satisfactory. The organization’s debt ratings reflect market confidence with S&P, Moody’s, and Duff & Phelps ratings of A1, P1, and 1+, respectively. In addition, the organization’s stock price continues to climb, closing at 55.00 on September 30, 1996, up from $42.35 a year ago.

Reputational Risk Management - Although First Bancorp has not formally considered reputational risk, senior management and the board appear well aware of the organization’s overall position. Reputational risk is monitored primarily through Bank of Nevada’s marketing department, which conducts surveys and studies on an ad hoc basis. Clear corporate ethics policies have been disseminated and the institution’s goals of quality and community service have been articulated to the staff. As a result, the possibility appears remote that negative publicity will lead to any significant decline in revenue or the customer base. This is evidenced by First Bancorp’s significant retail banking presence and stable core deposit base.
APPENDIX G

SUPERVISORY PLAN
SUPERVISORY PLAN

First Bancorp, Inc.  
Las Vegas, Nevada  
Total Assets: $20 Billion  
BOPEC: 2-2-2-2-2/2S, (06/30/96)

Responsible F.A. (FDIC): San Francisco  
Portfolio Manager: Bob Smith  
Phone: (415) 555-1249  
Date Prepared: 12/12/96

Overview

Areas identified in the prior full scope inspection and in the Risk Assessment are the focus of the supervisory plan for First Bancorp, Inc. (First Bancorp) during the next 18 months.

- **Competition and Integration of Recent Acquisitions** - The greatest challenges facing the company appear to be external, including fierce competition from both banks and nonbanks, as well as the ability of the company to remain independent in an environment of interstate banking. The ability to phase in the operations of the two newly acquired banks is also a challenge given the nominal due diligence performed by First Bancorp prior to the acquisitions. Providing an adequate management information systems (MIS) process that will accurately portray the market, liquidity, and credit risks of the organization on a fully consolidated and real time basis is complicated by the expanding scope of the company’s operations. First Bancorp’s strategies and progress in meeting these challenges will be assessed on an ongoing basis. In addition, the company’s success in achieving the goals of its strategic plan should be updated periodically. (The inspection as of June 30, 1996, noted satisfactory progress in meeting the goals of the plan). As specified in the strategic plan, task forces were formed for the purposes of determining goals for identified areas, and establishing road maps for achieving those goals before turning implementation over to various line units. Certain benchmarks have also been established to measure progress toward the goals.

- **Strategic Growth Initiatives** - Areas of potential expansion and growth should continue to be reviewed. Carson City and Reno are the targeted areas for growth. Management is exploring expansion in Reno, where First Bancorp is negotiating to purchase an operation with $85 million in assets. In addition, during the third quarter of 1996, First Bancorp entered into an agreement with one of California’s leading merchant banks, Lazard Trust - Los Angeles, to provide representative services for Bank of Nevada in California.

The only recent expansion of Utah operations is the pending acquisition of four American Bank branches by FNB Utah. Management has indicated that the Utah operation will most likely continue its gradual expansion via the acquisition of deposits. Growth opportunities within the Las Vegas market are strong. To this end, First Bancorp has

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1A Supervisory Plan would be classified as a "Restricted F.R." document.
introduced several new products and is offering incentives to existing customers to increase their number of products with the company. Business service centers, store banking, investment management, residential lending, and credit cards have also been targeted for their growth potential.

- **Problem Loan Levels** - Despite the company’s historical satisfactory asset quality, credit risk is a potential concern. The portfolios of the two new banks were not reviewed prior to acquisition. Consequently, the problem assets within these portfolios are not reflected in current classification ratios. In addition, nonperforming assets were on the rise during the third quarter of 1996, and reserve coverage of nonaccrual loans, although adequate, is dropping.

- **Information Systems and Personnel** - Operational risk is moderate and increasing. The inadequate due diligence related to the acquisitions is a concern, as is the absence of a formal methodology for converting the systems of an acquired institution. During its June 30, 1996 examination of the lead bank, the FDIC noted several MIS concerns related to the accuracy of loan trial balance information, the assimilation of the systems of the two new banks, and the integration of operations into the consolidated general ledger control system. A three-year program had been implemented by the bank to provide funding for updating technologies and should be reviewed periodically.

Management perceives the greatest risk to the institution is the possibility that it could be unable to attract and retain appropriate personnel to remain competitive. Even though First Bancorp has the financial capacity to purchase needed technology, the challenge of attracting and retaining qualified individuals could preclude the organization from spending all of its 1996 technology budget.

- **Market Risk Management Practices** - Market risk remains moderate and decreasing. Interest rate swaps purchased in 1993 and 1994 continue to amortize, and management currently has no plans for any additional hedging activities. Enhancement of interest rate risk management models is in process, and management is moving toward using Market Value of Portfolio Equity as First Bancorp’s primary risk measure. First Bancorp’s interest rate risk management practices should continue to be assessed using the guidance of SR 96-13 (SUP), the joint agency policy statement.

- **Trust Preferred Securities** - The company formally notified the Reserve Bank in December 1996 of its intentions to create a subsidiary trust company to issue $50 million in monthly income preferred stock (MIPS). The subsidiary trust will be known as First Bancorp Capital I Trust. The sole purpose of the Trust will be to issue preferred capital securities to qualified investors and to issue common securities, all of which will be owned by the First Bancorp. The proceeds generated by the sale of the preferred and common securities will be used by the Trust to purchase subordinated debt issued by First Bancorp. The issuance of the deeply subordinated debt can then be included as Tier
One Capital at the parent level as long as the issuance does not exceed 25 percent of Tier One capital. Another major benefit is that the interest payments on the debt are tax deductible at the holding company level. Management anticipates implementation by year-end 1996.

**Off-Site Monitoring**

First Bancorp has become a Top 50 company by virtue of its increased ownership in banks in Nevada in June of 1996. These transactions increased assets by approximately $1 billion. As of September 30, 1996, consolidated assets totaled $20 billion. As a Top 50 company, the corporation will provide certain reports on a quarterly basis.

**On-Site Inspections**

**Targeted Examinations**

*Bank Holding Company* - A joint review involving the FRB, FDIC, and NASD of mutual funds activity will be conducted in February 1997. During April 1997, an assessment of operations will also be conducted jointly between the FRB and the FDIC. Given that the 1995 and 1996 targeted reviews of interest rate risk resulted in satisfactory evaluations, additional targets of this area are not necessary. Instead, First Bancorp’s interest rate risk practices and overall risk management systems will continue to be reviewed at the full scope inspections.

*Subsidiary Banks and Thrifts* - The FDIC and State have scheduled no targeted reviews of Bank of Nevada other than those discussed under "Bank Holding Company," which could overlap into the lead bank. An informations systems (IS) targeted exam at Bancorp Nevada, Inc. will be conducted "sometime in 1997" according to the OTS. Due to asset quality deterioration disclosed at the most recent full scope examination of First National Bank of Utah, the OCC has scheduled a target examination focusing on asset quality during the first quarter of 1997.

**Full Scope Inspection/Examinations**

*Bank Holding Company* - The inspection of the holding company and its nonbanks by the FRBSF will occur during the third quarter of 1997. The scope of the inspection will incorporate follow-up on the findings from the 1996 inspection, including recommendations related to enhancing risk management practices. The findings of the most recent full scope examinations of the lead bank and the Nevada thrift will also be reviewed. The evaluation of First National Bank (FNB) of Utah has typically been limited due to its small size. However, management plans to continue to gradually grow the Utah bank. As a result, an evaluation of FNB of Utah may have to be included in the report. In addition, the review of the thrift in Wadsworth can remain limited due to its size and strong financial profile.
Functions centralized at the holding company, such as credit review and internal audit, should be assessed at each inspection. Other areas of focus include consolidated operations, strategic planning, parent cash flow, leverage and liquidity. Risk profiles will be updated as appropriate. Any appropriate follow-up from the targeted reviews scheduled during the first two quarters of 1997 (mutual funds and international operations) should also be addressed. In light of the limited review conducted prior to the acquisitions, and the company's ongoing expansion, due diligence processes should be evaluated. Additionally, an MIS review should be conducted to focus on the company's process for monitoring, reporting, and managing risk. The prior inspection report noted significant manual intervention and concerns over the integration of out-of-state operations. The stock repurchase and commercial paper programs of the holding company will also be analyzed. Review of the three active nonbanks will be limited due to their satisfactory conditions and immaterial size.

**Subsidiary Banks and Thrifts** - Examinations of the commercial banks and thrifts will be conducted by the applicable primary regulators. The examination of Bank of Nevada by the FDIC usually occurs during the summertime, using June 30 financial information. At the 1996 examination, the State of Nevada joined the FDIC and a joint report was issued.

FNB of Utah is on an 18 month examination cycle. Thus, the next full scope examination is scheduled during the second quarter of 1997. The prior examination was conducted in April 1996 with an as of date of December 31, 1995. CAMEL ratings from that examination were 23212/2.

First Fed Nevada, Inc. in Las Vegas was rated "1" as of June 30, 1996, and is on an annual cycle. Federal Savings & Loan Association in Wadsworth was rated "1" following its examination during the first quarter of 1996, and is on an 18 month cycle. The next examination of these thrifts will occur during the third quarter of 1997.

**Nonbank Subsidiaries** - The scope of review for the three active nonbank subsidiaries is typically limited and can be conducted off-site since activities are insignificant to the consolidated organization. As of the previous inspection, the nonbanks represented a nominal 0.1 percent of consolidated assets and were all considered to be in satisfactory condition. The three nonbanks are mortgage related. Given recent regulatory rulings, a determination should be made whether management intends to expand nonbank activities.

**Compliance and CRA** - A joint compliance and CRA review including all applicable regulatory agencies (FRB, FDIC, OCC, OTS, and State) will be scheduled for the first quarter of 1997. The most recent compliance and CRA examination of the lead bank was conducted as of June 30, 1996, and ratings were satisfactory. Compliance and CRA were also rated satisfactory at the Utah bank following the OCC's examination in April 1996. The OCC has tentatively scheduled the second quarter of 1997 for the next compliance and CRA exam.

Both thrifts received satisfactory ratings at the compliance reviews conducted as of June 30, 1996. The OTS indicated that compliance and CRA examinations of the two thrifts are ideally
scheduled to run concurrently with the safety and soundness examinations, although this does not always occur.

**Fiduciary** - Bank of Nevada is the only institution with a trust operation. Las Vegas Trust Company, Ltd. (LVTC), a subsidiary of the lead bank, was most recently examined by the FDIC as of April 30, 1996, and received ratings of 222221/2. The examination cycle for the trust operation is 12 months; the FDIC tries to schedule the exam of LVTC concurrent with the safety and soundness exam of Bank of Nevada or as close to it as possible.

**Edge Act Corporation** - Bank of Nevada International is located in Chicago. The company has total assets of $150 million with a $20 million loan portfolio. The Federal Reserve Bank of Chicago was scheduled to examine the company starting in November 1996; however, the results of the review were not available as of this writing.

**Bank of Carson City** - Current regulatory report not yet available.

**Bank of Winnemuca** - Current regulatory report not yet available.

## Execution of the Supervisory Plan

### Staffing

The June 30, 1996 inspection of the holding company was a joint effort between the FRBSF and the OTS with a joint report being issued. Similarly, the 1996 examination of the Bank of Nevada was conducted jointly by the FDIC and the State of Nevada, and a joint report was also issued for the lead bank. Future inspections and examinations should continue to be joint efforts.

As previously indicated, targeted reviews in 1997 of mutual funds and a compliance and CRA assessment will involve multiple regulatory agencies.

### Coordination

Quarterly conference calls will be held with all involved regulatory agencies to discuss needed changes to the Supervisory Plan, progress on meeting time frames set forth in the examination program, and any material current events. In addition, conference calls will be held with all involved regulatory agencies to discuss the findings of any targeted exams.

### Revisions to Plan

At least annually, the FRBSF will: 1) review the appropriateness of the Risk Assessment; 2) revise the Supervisory Plan with all relevant agencies; and 3) evaluate the execution of the Supervisory Plan and compliance with mandates.
APPENDIX H

EXAMINATION PROGRAM
## EXAMINATION PROGRAM

First Bancorp, Inc. (FBI)  
Las Vegas, Nevada  
Total Assets: $20 Billion  
BOPEC: 2-2-2-2-2, (6/30/96)  

<table>
<thead>
<tr>
<th>ENTRY DATE</th>
<th>DURATION</th>
<th>PROJECT &amp; SCOPE</th>
<th>AREAS OF EMPHASIS</th>
<th>WORKDAYS NEEDED</th>
<th>AGENCY &amp; STAFFING (*LEAD)</th>
<th>PRODUCT</th>
<th>DELIVERY DATE</th>
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</thead>
<tbody>
<tr>
<td>05/97</td>
<td>6 Weeks</td>
<td>Trust Exam Las Vegas Trust Co.</td>
<td>Review Trust Operations</td>
<td>240</td>
<td>FDIC*-6, FRB-2</td>
<td>FDIC Report</td>
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<tr>
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<td>2 Weeks</td>
<td>Target Exam of FBI</td>
<td>Mergers and Acquisitions</td>
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<td>FRB*-3, FDIC-1</td>
<td>FRB Memo &amp; Letter</td>
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<td>NASD*-4, FRB-1, FDIC-1</td>
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<td>OCC*-5</td>
<td>OCC Report</td>
<td>08/30/97</td>
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<td>All CAMELS Components</td>
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<td>FRB*-5</td>
<td>FRB Report</td>
<td>12/01/97</td>
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1An Examination Program would be classified as a "Restricted F.R." document.
APPENDIX I

SCOPE MEMORANDUM
Federal Reserve Bank
Internal Communication

Banking Supervision and Regulation

April 10, 1997

To: File
From: Bob Smith,
    Portfolio Manager
Subject: Full Scope Examination of Bank of Nevada

A full scope examination of Bank of Nevada (BN) is scheduled to commence on August 4, 1997, using financial information as of June 30, 1997. The bank’s risk management processes will be evaluated, with particular emphasis on BN’s practices relative to operational risk, credit risk, and liquidity risk. Areas of potential expansion and growth will also be reviewed, as well as processes for managing the associated risks. In addition, all CAMELS components will be evaluated. Mutual funds will not be assessed at this examination since a multi-agency review of this activity was conducted during the first quarter of 1997.

RISK MANAGEMENT PROCESSES

BN employs a satisfactory risk management system. Overall, policies, procedures, and internal controls are generally satisfactory as well. The bank maintains written guidelines covering the six areas of risk listed in SR 95-51, which are subject to regular review and revision. In addition, the current internal controls are satisfactory based on the institution’s FDICIA 112 self-assessment, as well as the lack of significant criticism based on a review of internal and external audit reports, evaluations by outside consultants, and regulatory reviews. Given the overall integrity of these processes, we will place a high level of reliance on internal risk management systems, and internal and external audit findings. Accordingly, the examination will consist of only a moderate level of testing.

Areas of moderate risk include operational, credit, and liquidity. BN’s ongoing growth also presents issues of moderate risk. The moderate level of risk is primarily associated with the bank’s future ability to maintain satisfactory internal controls, a meaningful management information systems (MIS) process, and appropriate due diligence associated with acquisitions.

EXAMINATION FOCUS

Following are key issues subject to review that are related to operational risk, credit risk, liquidity risk, and expansion plans. Additional detail is contained in the Risk Assessment and Supervisory Plan.

---

1A Scope Memorandum would be classified as a "Restricted F.R." document.
Operational Risk

- Ability to implement and maintain satisfactory internal controls given continual expansion.
- Integration of systems and the resultant ability of the MIS process to capture risks.
- Nominal due diligence conducted prior to acquiring majority ownership interests in two banks.
- Ability to convert the systems of acquired entities given that the bank has not formalized a methodology for this process.

Credit Risk

- Recent increases in nonperforming assets.
- Effect on classification levels if the portfolios of the two acquired banks are included.

Liquidity Risk

- Continued reliance on foreign deposits as a significant funding source.
- Ability to attract desired levels of core deposits.

Growth

In June 1996, the company increased its ownership position at Winnemucca First National from 30 percent to 90 percent, and increased its ownership position at the Bank of Carson City from 32 percent to 73 percent. Winnemucca First National and Bank of Carson City have assets of $400 million and $900 million, respectively. Carson City and Reno are the targeted areas for growth. Given the ongoing and rapid expansion, BN’s processes relative to the following merger and acquisition functions will be reviewed:

- Strategic planning
- Candidate selection
- Due diligence
- Pricing/negotiation
- Transition and integration
- Post-merger performance

Compliance with internal processes related to acquisition activities will be conducted through review of the Winnemucca First National and Bank of Carson City transactions.

CAMELS COMPONENTS

The previous examination, conducted as of June 30, 1996, resulted in CAMEL ratings of 22222/2. BN is well managed and has a record of long-term earnings growth and solid financial performance strengthened by Nevada’s growing economy. Capital remains adequate with all
ratios above "well-capitalized" thresholds.

Both asset quality and liquidity, although satisfactory, represent areas of potential concern and will be subject to heightened focus during the examination. Classification ratios do not include problem assets from newly acquired entities. In addition, nonperforming assets are on the rise. The bank continues to rely on foreign deposits, and core deposits are at below budgeted levels.

Asset Quality

As of September 30, 1996, total and weighted classification ratios were 42 percent and 10 percent, respectively, which represents a decrease from prior quarter levels and the first decrease since the end of 1995. However, classifications do not include potential problem assets from the newly acquired banks, which substantially increased the portfolio of commercial and industrial loans. In addition, nonperforming loans rose to 1.8 percent of total loans, compared to 1.1 percent at the end of the second quarter of 1996.

Examination Focus - The effects of the inclusion of problem assets from the acquired banks will be determined, as well as management’s plans for reducing problem asset levels. Review of credit files should be limited to 25 percent of loans, with a concentrated focus on the acquired portfolios.

Liquidity

The bank continues to rely on a significant level of foreign deposits to fund activities. These deposits have proven to be stable. Foreign deposits represent 30 percent of the company’s total deposits at September 30, 1996, representing an increase from 26 percent at December 31, 1995. The increase is primarily associated with the acquisition of the Winnemucca and Carson City banks. In addition to foreign deposits, the bank maintains a high level of state and local government funds. These public deposits have historically been stable.

Strong competition, not only from banks and thrifts, but also from securities brokerage firms, continues to negatively impact the bank’s ability to attract desired levels of core deposits. BN is continuing its efforts to increase its level of core deposits.

Examination Focus - Documentation relative to the stability of foreign deposits will be reviewed, as will management’s plans for increasing the bank’s core deposit levels.

Other CAMELS Components

The review of earnings, capital, and market sensitivity will be limited to performing the procedures necessary to support CAMELS component ratings. The adequacy of the bank’s risk management practices will be an important factor in determining the rating assigned to the
management component.

WORK PROCEDURES

Off-site Procedures

A pre-examination meeting with senior management of BN was conducted on April 7, 1997. Key management reports were provided at the meeting, and a review of these items has been incorporated in the preparation of this scope memorandum. In addition, the four products (Institutional Overview, Risk Assessment, Supervisory Plan, and Examination Program) were heavily relied upon in pre-examination planning efforts.

On-site Procedures

In general, the six risk areas will be assessed through interviews with senior management, as well as through reviews of policies, procedures, and other documents. Conclusion memoranda will be prepared for each of the six areas of risk. Where appropriate, conclusions on the CAMELS components can be incorporated into these memoranda (e.g. the conclusion memorandum addressing credit risk can incorporate asset quality conclusions). Work programs will be available, but should only be relied on as supplemental tools.

OTHER COMMENTS

The report of examination format will be streamlined to reflect the risk-focused nature of the examination, featuring comments on the banks operational, credit, liquidity and expansion processes, as well as other concerns that arise during the examination. Furthermore, the report will have comments pertaining to all CAMELS components, with the length of those comments correlated to the severity of our findings.

The budgeted examination workdays reflect a 20 percent reduction from the previous examination. More resources are shifting from credit and financial analysis to information systems and expansion plan review. In addition, off-site preparation for the examination has increased 10 percent from the previous year.
APPENDIX J

ENTRY LETTERS FOR

(1) COMBINED BANK HOLDING COMPANY INSPECTION
    AND STATE MEMBER BANK EXAMINATION

(2) STATE MEMBER BANK EXAMINATION

(3) BANK HOLDING COMPANY INSPECTION
INSTRUCTIONS FOR
ENTRY LETTER

Entry letters for state member banks (SMBs), bank holding companies (BHCs),
and combined bank/holding companies have been revised to more closely align with the risk-
focused approach taken in the new examination modules for large complex institutions and to
reduce some of the paperwork burden on the examined institution.

Obsolete, redundant, and particularly burdensome requests have been eliminated,
resulting in shorter and more focused entry letters. Many of the eliminated items generally related
to information that may still be useful, although not essential, to examiners. Their elimination
does not mean that these items should not be covered during an examination/inspection.
However, in many instances, the information request were the type of requests can just as easily
and efficiently be made orally during the on-site examination and do not require a written
response.

The structure of the new entry letters, for both SMBs and BHCs, has also been
changed to allow for easier completion and more adaptability to specific jobs. Each entry letter
has a core section of required information that is pertinent to all large institutions, regardless of
size or complexity. In addition to the core requests, supplementary questionnaires should be used
as needed for the specialized areas such as asset securitization/sales, information systems, private
banking, securities clearance/lending, trading activities, and transfer risk.

Each of the questionnaires include specific cover letters for use in SMBs, BHCs,
and combined bank and holding company examinations. The cover letters must be used (although
they can be modified) as they provide specific guidance to the examined institution.

The new entry letters direct management to provide written responses and copies
of specific documents requested only if the requested information is new or has changed since the
previous examination or inspection. Moreover, we are no longer requesting that management
provide examiners with copies of the institution's regulatory reports filed with the Federal Reserve
or other bank regulatory agencies. These reports should be gathered from internal sources during
the pre-examination planning process. A listing of the reports that should be available internally
are listed in the attachment to these instructions. The examiner-in-charge should always review
anticipated information and document needs with the central point of contact for the examined
institution prior to the mailing of any entry letter.

Consistent with the current practice, the entry letters should be used as a starting
point, or template, in preparing for an examination or inspection. The entry letters should be
tailored during the planning process to fit the proposed scope and profile of the institution to be
examined. Information requests that may be either irrelevant or not appropriate given the profile
of the institution should be eliminated.
The new entry letters request internal management information reports for each of the key examination areas, rather than reports specifically designed for examiners. Internal management reports should be used in all instances. If they do not provide sufficient information to examine the institution, then it would appear that management is not adequately informed, and this may well be the first examination finding.
ENTRY LETTER FOR

(1) COMBINED BANK HOLDING COMPANY INSPECTION AND STATE MEMBER BANK EXAMINATION
THE FEDERAL RESERVE BANK
COVER LETTER

INSPECTION AND EXAMINATION QUESTIONNAIRE FOR
COMBINED BANK HOLDING COMPANY INSPECTION AND
STATE MEMBER BANK EXAMINATION

In order to facilitate the inspection and examination of your organization, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date (______________). You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous examination, which was conducted as of (______). Please indicate no change where applicable. For each area covered by this questionnaire, please provide copies of the most recent reports used by management to administer and monitor the respective areas. Please note that examiners may make additional requests during the examination.

Single copies of all submissions in response to our requests will be satisfactory unless otherwise indicated and should be delivered to the examiner-in-charge or designee. Any requests for clarification or definition of terms should also be directed to the examiner-in-charge.

In order to expedite the examination, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating "N/A" if a question is not applicable to your organization.

Most of the requested data will not be needed until the commencement of the examination, which is (__________). However, certain information may be needed earlier. Such information and the date due will be discussed with you.

____________________________________  ________________________
Federal Reserve Examiner-in-Charge    Telephone
FEDERAL RESERVE BANK
COMBINED BANK HOLDING COMPANY INSPECTION
AND STATE MEMBER BANK EXAMINATION QUESTIONNAIRE

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Section 9 Bank Secrecy Act
Section 10 Loans to Executive Officers, Directors, Principal Shareholders
Section 11 Related Organizations
Section 12 Bank Communication/Funds Transfer Systems
Section 13 Miscellaneous
Section 1 - Financial Reports and Details of Accounts

Please provide:

1. General ledger trial balances as of (date).

2. Consolidating statements of assets and liabilities and income and expense, including schedules of eliminations.

3. Copy of the latest financial projections or strategic business plan(s) for the current full year and the next year. Please include the assumptions used in the preparation of the projections.

4. Copies of income statements and budget to actual performance reports for the latest year and current year-to-date for significant operating areas, departments, and business lines.

5. a) Organization chart of management by legal entity and functional business lines, if different, indicating lines of authority and allocation of duties for all key business lines and support areas of the organization (include all those indicated in this questionnaire).

   b) List of key contact personnel for each significant operating area, department, and functional group.

   c) Organization chart of the consolidated corporation and the bank by legal entity showing percent ownership if less than 100%.

Section 2 - Management, Directorate and Shareholders

Please provide:

1. List of directors showing place of residence, years on the board, year of birth, principal occupation or business affiliation, and connection with other banking or securities firms. Additionally, please indicate memberships on directors' committees. Indicate the frequency of scheduled meetings of the board of directors and board committees and provide details on fees, if any, paid to directors.

2. Brief biography of each director elected or senior management appointed since the previous examination. Include senior management of each of the operating areas covered under the supplemental questionnaires, if applicable.

3. List of executive officers, as defined in Regulation O, showing title, area of responsibility, year of birth, years with bank, years in present position, and compensation.
4. List of all committees of senior management including names and titles of members, mission, and authority.

5. Copy of the latest directors’ examination report and management’s response.

6. Information with respect to any director, officer, or employee considered to be a "Management Official" as defined in Regulation L and who is acting in any capacity for any nonaffiliated depository institutions, bank holding companies, and savings and loan holding companies with their principal offices in the United States.

7. List of each principal shareholder of the bank (5% or more of any class of voting stock), and the respective percentage of ownership. When the principal shareholder is a bank holding company, list its principal shareholders (5% or more of any class of voting stock), and the percentage of shares controlled.

Section 3 - Loans and Other Extensions of Credit

The following requests include all exposures that are administered by the bank/bank holding company or separately administered by subsidiaries. All terms shall be as defined in the instructions for completing the Consolidated Reports of Condition and Income.

Please provide (identify booking vehicle where applicable):

1. Alpha trial balances for commercial, instalment, real estate, credit card, and any other loan categories as of (date). The list should include commitments and outstanding amounts, country of domicile (if other than U.S.) and maturity dates. If applicable, provide internal credit risk ratings for each exposure. If possible, also provide the above by relationship. If amounts include participations sold, so indicate.

2. Copies of key MIS reports used by executive management and the directorate to monitor asset quality.

3. Copies of any new policies and procedures and changes to existing policies and procedures implemented since the prior examination.

4. A copy of the latest quarterly analysis of the adequacy of the loan loss reserve, any other credit-risk reserves, and provisions thereto.

5. List of all other real estate owned, indicating outstanding balance (book value and market value), most recent appraised value, and appraisal date.

6. List of all loans for which the organization holds its own stock or holds stock of its bank holding company or of other affiliates as collateral for a loan.
7. Describe any arrangements whereby the organization, either for its own account or for others, guarantees the payment of any loan or the performance of any other undertaking.

8. List of past due loans (principal and/or interest), indicating amount of loan and date past due. Include totals for the following delinquency intervals: 1-30 days, 31-89 days, 90-119 days, 120-179 days, and 180 days or more. Consumer loans and residential mortgages should be shown by product category totals.

9. List of nonaccrual loans and any other nonaccrual credit exposures. Include date placed on nonaccrual.

10. List of loans which have been restructured or renegotiated, amounting to $_____ or more, on which a) principal and/or interest has been waived, or b) interest has been capitalized, deferred or suspended, including the amount of interest waived since the previous examination and the date of the waiver. The list should include loans that have been renewed or extended without collection of accrued interest or where notes or capital stock have been accepted in lieu of unpaid interest or principal.

11. A detailed list of participations purchased and sold as of (date).

12. List of any exposure concentrations of 25% or more of Tier I capital and loan loss reserve by industry and borrower/borrower group.

13. A reconciliation of shared national credits (SNC) balances since the latest SNC review.

14. Volume of any loan sales and list of counterparties for last calendar year and projections for the current year.

15. List of any failed syndications since the previous examination.

Section 4 - Investment Securities & Brokerage Activities

Please provide:

1. Any new policies and procedures and changes to existing policies and procedures implemented since the prior examination.

2. Copies of key MIS reports used to monitor the investment portfolio.

3. List of investment securities by held to maturity and available for sale designation, giving par, book and market values, and maturity dates.

4. List of pledged securities (par, book and market value).
5. List of purchases or sales of securities or other assets with either written or oral agreements to resell or repurchase.

6. List and description of any arrangements which could, in any way, move positions or transfer risk to/from the reporting entity to any related affiliates.

7. Identify any credit derivatives associated with the investment account.

8. Copy of the organization's fee schedule for all types of brokerage transactions.

9. Aging schedule of "fails" to receive or deliver securities on unsettled transactions. Provide fail date, reason, and action taken.

10. A listing, including amounts, of all high risk mortgage backed securities.

Section 5 - Liquidity/Funds Management and Deposit Liabilities

Please provide:

1. Copies of all key management reports used to monitor all aspects of liquidity and funds management.

2. Any new policies and procedures and changes to existing policies and procedures implemented since the prior examination.

3. Details of sources of credit available to the organization. Identify any restrictions, if applicable.

4. List of the largest individual funding sources.

5. Details on lines of credit that are reciprocal between the lender and the corporation or its subsidiary banks.

6. Description of any commercial paper programs issued by this or any related institution, including the following information:
   a) Size of the program,
   b) Yield as compared to the Federal Reserve composite,
   c) Level of distribution and any changes in distribution over the last twelve months, and
   d) Holdings in excess of 10% by any individual or entity.
7. Details on those entities which maintain compensating balances. Indicate any restriction placed on those accounts.

8. Details on unaffiliated borrowings of the consolidated organization.

9. Details on parent company's extensions of credit to or from subsidiaries indicating:
   a) Name,
   b) Origination date and amount,
   c) Purpose,
   d) Collateral, if any,
   e) Interest rate,
   f) Maturity date,
   g) Repayment schedule and/or sinking fund requirements, and
   h) Whether advance qualifies as Tier I or Tier II capital.

10. Parent company cash flow figures for the latest, current and next fiscal year. Please make workpapers available for review.

11. List of the largest deposit balances aggregated by entity/related entities.

12. List of deposits by principal shareholders, directors, and executive officers of the institution by deposit type, amount, rate, origination date, and maturity date.

13. List of all brokered deposits including amount, rate, and maturity.

Section 6 - Interest-Rate Sensitivity

Please provide:

1. Copies of any new or revisions to existing policies and procedures for managing interest-rate sensitivity since the last examination, including methodologies, underlying assumptions, limit structure, and compliance.

2. Copies of all interest-rate sensitivity reports including scenario analyses used by management. Please include a repricing schedule/gap analysis which account for any hedged positions.
3. Copies of any audits performed regarding the asset/liability management process and/or interest rate sensitivity models.

4. Documentation for any interest rate risk models used. Specify major assumptions for each model (e.g. - prepayment speeds, core-deposit assumptions, deposit lag, and loan spreads).

5. Details on and results of any recent "stress" tests conducted.

6. Listing of off-balance sheet activities including interest rate futures, forwards, swaps, caps, collars, and floors. Also describe how these items are used to manage interest rate risk.

**Section 7 - Off-Balance-Sheet Items**

Please provide:

1. List of participations in this institution’s acceptances, letters of credit, and standby letters of credit conveyed to others.

2. List of participations in other institution’s acceptances, letters of credit, and standby letters of credit acquired by this institution.

3. List of other significant off-balance-sheet items, including:
   a) Securities lent,
   b) When issued securities (commitments to purchase and commitments to sell),
   c) Securities borrowed, and
   d) Other items.

4. The names of any individual or committee responsible for controlling and monitoring off-balance-sheet risks.

5. Any new or revisions to existing policies and procedures relating to the booking of off-balance-sheet items implemented since the last examination.

**Section 8 - Auditing and Internal Controls**

The information requested in this area refers to audit and internal control material not specifically requested in other sections. Please provide a list of audit reports prepared since the previous
examination promptly at examination commencement. Copies of specific audit reports will then be requested.

Please provide:

1. Information on the current year’s audit plan and schedule:
   a) Copy of the audit program and/or plan presented to the Audit Committee for the current year and any quarterly updates;
   b) All reports issued to the Board of Directors, Audit and/or Examining Committee and senior management summarizing audit activities and findings since the last examination;
   c) If an outside C.P.A. firm or other organization provides audit services and/or assists at the annual directors’ examination, the firm’s name, address, and contact person and copies of the most recent:
      - Audit report
      - Engagement letter
      - Management letter and reply

2. Description of audit planning and/or risk assessment methodology used in preparing the annual audit schedule.

3. Description of the extent of audit coverage regarding any functions/activities which are out-sourced by the institution.

4. If a separate EDP Examination Questionnaire is not provided, list the name and location of each facility performing electronic data processing including off-premise servicers, and list the perspective applications processed. Provide a contact person for each application listed.

Please make available:

5. Minutes of the Examining and/or Audit Committee since the previous examination.

6. Internal risk assessments of significant business activities, if available.

Section 9 - Bank Secrecy Act

Please provide:

1. Copies of any new and revisions to existing policies and procedures implemented since the
prior examination, including those policies and procedures pertaining to compliance with the Office of Foreign Asset Control (OFAC) laws and regulations.

2. Make available operating manual(s) containing Bank Secrecy Act (BSA) procedures for branch office and teller operations.

3. A list of accounts for whom the bank does not have taxpayer identification numbers.

4. A copy of the most recent internal and external audit reports that relate to compliance with BSA, and management’s responses.

5. Make available a copy of the BSA training program.

6. Lists of exempt customers with which transactions are conducted.

7. Make available copies of (filed since prior examination):
   a) Currency Transaction Report (Form 4789),
   b) Currency & Monetary Instruments Report (Form 4790),
   c) Report of Foreign Accounts (Form 90-22.1), and
   d) Suspicious Activity Report (Form 2230).

8. If the bank offers Payable Through Accounts, provide a list of these accounts and describe monitoring procedures.

   **Section 10 - Loans to Executive Officers, Directors and Principal Shareholders**
   (See Regulation O for applicable definitions.)

Please provide the following for questions 1, 2, and 3:

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<tr>
<th>Borrower's Name</th>
<th>Present Balance</th>
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<tr>
<td>Endorser or guarantor</td>
<td>Repayment Terms</td>
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<tr>
<td>Date of Loan</td>
<td>Collateral Pledged and Market Value</td>
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<td>Interest Rate</td>
<td>Original Amount</td>
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<tr>
<td>Purpose</td>
<td>Date approved by the Board</td>
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1. List of direct and indirect extensions of credit by the bank, including overdrafts, to the following individuals and their related interests:

   a) Executive officers of the bank, of the holding company, and of any of its subsidiaries;
b) All other officers of the bank, bank holding company, or subsidiary of the bank holding company;

c) Principal shareholders of the bank and the bank holding company;

d) Directors of the bank, of the bank holding company, and of any subsidiary of the bank holding company; and

e) Executive officers, directors and principal shareholders of a correspondent bank.

2. List of direct and indirect extensions of credit by the bank or a correspondent bank to:

   a) The bank holding company and its subsidiaries;

   b) Any company where the majority of directors also constitutes a majority of the directors of the bank or of the bank holding company; and

   c) Any other affiliate as defined by Regulation Y.

3. Loans by the organization to any borrowers secured by stocks, bonds, or other obligations of a related interest of a bank official.

4. Copies of required annual reports filed by executive officers and principal shareholders on indebtedness to this organization’s correspondents (Form FFIEC 004).

5. List of the names and addresses of this organization’s correspondent banks, as defined in Subpart B of Regulation O.

6. List of the bank’s investment in stocks, bonds, or other obligations of corporations in which bank officials are known to have a substantial interest.

Section 11 - Related Organizations

Please provide:

1. For new subsidiaries formed or acquired since the previous inspection, and changes, where applicable, on existing subsidiaries:

   a) Name,

   b) Location,

   c) Date acquired or formed,
d) Percentage of ownership,

e) Nature of business,

f) Balance sheet and income statement for latest fiscal year and as of examination date,

g) Off-balance-sheet activities,

h) Management contact person, and

i) List of officers and directors of each subsidiary and affiliate.

2. For all subsidiaries, other than those under #1 above, a balance sheet and income statement for the latest fiscal year and current year to date.

3. If fee income is received from subsidiaries, on what basis are they determined?

4. List and describe: (a) services offered to any subsidiary by the bank or affiliates; (b) services offered to the bank by its subsidiaries or parent; (c) services offered to customers of the bank by any non-bank subsidiary; and (d) services between the "Section 20" company (if applicable) and its affiliates.

5. Excluding affiliates arising pursuant to the Bank Holding Company Act of 1956, as amended, does the bank have other affiliates as defined by Section 23A (b)(1) of the Federal Reserve Act? If so, indicate for each affiliate (a) name and location; (b) nature of business as authorized by charter and as presently conducted; (c) manner of affiliation; (d) period of existence as such; (e) purpose of affiliation and circumstances under which it arose; and (f) number of shares of stock of bank owned or controlled and the number voted by each affiliate at last election of directors of the bank.

6. List (a) any loan or extension of credit to or for the benefit of an affiliate; (b) any investment in any securities, notes, or other assets acquired under a repurchase agreement, purchased from, or sold to an affiliate; (c) any investment in, or any loans or extensions of credit collateralized by capital stock, bonds, debentures, or other such obligations issued or guaranteed by an affiliate; and (d) any guarantees, acceptances, and letters of credit on behalf of an affiliate.

7. If any of the bank’s functions have been transferred to the bank holding company, a holding company subsidiary, or other bank affiliates since the previous examination, provide details.

8. Have any low quality assets (see Federal Reserve Act Section 23A(b)(10) for definition) been purchased or committed to be purchased by the bank from an affiliate? If so, provide
details.

9. Has the bank extended credit or furnished services with the condition that the customer enter into a tie-in arrangement with any of its affiliates as defined in section 106(b) of the Bank Holding Company Act Amendments of 1970?

10. Does the organization file a consolidated tax return? If so, submit a copy of the written tax sharing agreement with subsidiaries that specify intercorporate tax settlement policies.

**Section 12 - Miscellaneous**

Please provide:

1. Provide a risk management policy or describe how risks (e.g. - credit, market, operational, liquidity, reputational, and legal) are identified, evaluated, monitored and controlled throughout the organization. (If submitted in response to other requests in this questionnaire, indicate which request.)

2. Description of and details on any new significant financial products or activities introduced/commenced since the prior examination. Describe the new products/activities approval process. Provide copies of any management reports regarding these products/activities.

3. Analysis and documentation supporting the self assessment of payments system risk and evidence of review by the organization’s board of directors.

4. Copies of any written procedures for the selection and termination of correspondent relationships as well as the periodic review of correspondents' financial condition. Please provide an assessment of the general rating criteria used by rating agencies whose evaluations are used in the selection, termination, or monitoring of correspondent relationships.

5. Policies and procedures relating to Regulation F and any supporting policies or sections thereof that may be referenced within the Regulation F policy.

6. A copy of the proxy statement.

7. A detailed schedule of fidelity bond and general liability insurance. The schedule should list in detail all areas covered for loss/liability.

8. Make available the corporation’s latest quarterly litigation report describing any significant pending or threatened litigation or investigations against the organization or against any director, officer, or policy-making employee in their official capacity; with the following information:
a) name(s) of the plaintiff(s),

b) nature of the claim and the damages requested,

c) current status, and

d) an opinion of the probable outcome of the litigation, including an estimation of the organization’s liability.
ENTRY LETTER FOR
(2) STATE MEMBER BANK EXAMINATIONS
THE FEDERAL RESERVE BANK
COVER LETTER

STATE MEMBER BANK EXAMINATION
QUESTIONNAIRE

In order to facilitate the examination of your organization, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date (________________). You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous examination, which was conducted as of (_______). Please indicate no change where applicable. For each area covered by this questionnaire, please provide copies of the most recent reports used by management to administer and monitor the respective areas. Please note that examiners may make additional requests during the examination.

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In order to expedite the examination, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating "N/A" if a question is not applicable to your organization.

Most of the requested data will not be needed until the commencement of the examination, which is ______________. However, certain information may be needed earlier. Such information and the date due will be discussed with you.

________________________________________  _________________________
Federal Reserve Examiner-in-Charge  Telephone
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Please provide:

1. General ledger trial balances as of (date).

2. Consolidating statements of assets and liabilities and income and expense, including schedules of eliminations.

3. Copy of the latest financial projections or strategic business plan(s) for the current full year and the next year. Please include the assumptions used in the preparation of the projections.

4. Copies of income statements and budget to actual performance reports for the latest year and current year-to-date for significant operating areas, departments, and business lines.

5. a) Organization chart of management by legal entity and functional business lines, if different, indicating lines of authority and allocation of duties, including management reporting relationships for all key areas of the organization (include all those indicated in this questionnaire).

   b) List of key contact personnel with telephone numbers for each significant operating area, department, and functional group.

   c) Organization chart of the bank by legal entity showing percent ownership if less than 100%.

Section 2 - Management, Directorate and Shareholders

Please provide:

1. List of directors showing place of residence, years on the board, year of birth, principal occupation or business affiliation, and connection with other banking or securities firms. Additionally, please indicate memberships on directors' committees. Indicate the frequency of scheduled meetings of the board of directors and board committees and provide details on fees, if any, paid to directors.

2. Brief biography of each director elected or senior management appointed since the previous examination. Include senior management of each of the operating areas covered under the supplemental questionnaires, if applicable.

3. List of executive officers, as defined in Regulation O, showing title, area of responsibility, year of birth, years with bank, years in present position, and compensation.
4. List of all committees of senior management including names and titles of members, mission, and authority.

5. List of each principal shareholder of the bank (5% or more of any class of voting stock), and the respective percentage of ownership. When the principal shareholder is a bank holding company, list its principal shareholders (5% or more of any class of voting stock), and the percentage of shares controlled.

6. Information with respect to any director, officer, or employee considered to be a "Management Official" as defined in Regulation L and who is acting in any capacity for any nonaffiliated depository institutions, bank holding companies, and savings and loan holding companies with principal offices in the United States.

Section 3 - Loans and Other Extensions of Credit

The following requests include all exposures that are administered by the bank or separately administered by its subsidiaries. All terms shall be as defined in the instructions for completing the Consolidated Reports of Condition and Income.

Please provide (identify booking vehicle where applicable):

1. Alpha trial balance for commercial, instalment, real estate, credit card, and any other loan categories as of (date). The list should include commitments and outstanding amounts, country of domicile (if other than U.S.) and maturity dates. If applicable, provide internal credit risk ratings for each exposure. If possible, also provide the above by relationship. If amounts include participations sold, so indicate.

2. Copies of key MIS reports used by executive management and the directorate to monitor asset quality.

3. Copies of any new policies and procedures and changes to existing policies and procedures since the prior examination.

4. A copy of the latest internal analysis of the adequacy of the loan loss reserve, any credit-risk reserves, and provisions thereto.

5. List of all other real estate owned, indicating outstanding balance (book value and market value), most recent appraised value, and appraisal date.

6. List of all loans for which the organization holds its own stock or holds stock of its bank holding company (if applicable) or of other affiliates as collateral for a loan.

7. Describe any arrangements whereby the organization, either for its own account or for
others, guarantees the payment of any loan or other debt obligation or guarantees the performance of any other undertaking.

8. List of past due loans (principal and/or interest), indicating amount of loan and date past due. Include totals for the following delinquency intervals: 1-30 days, 31-89 days, 90-119 days, 120-179 days and 180 days or more. Consumer loans and residential mortgages should be shown by product category totals.

9. List of nonaccrual loans, and any other nonaccrual credit exposures. Include date placed on nonaccrual.

10. List of loans which have been restructured or renegotiated, amounting to $\_\_\_\_\_\_\ or more, on which a) principal and/or interest has been waived, or b) interest has been capitalized, deferred or suspended, including the amount of interest waived since the previous examination and the date of the waiver. The list should include loans that have been renewed or extended without collection of accrued interest or where notes or capital stock have been accepted in lieu of unpaid interest or principal.

11. A detailed list of participations purchased and sold as of (date).

12. List of any exposure concentrations of 25% or more of Tier I capital and loan loss reserve by industry and borrower/borrower group.

13. Describe the internal credit risk-rating system.

14. Provide volume of any loan sales and list of counterparties for last calendar year and projections for the current year.

15. List of any failed syndications since the previous examination.

**Section 4 - Investment Securities**

Please provide:

1. Any new policies and procedures and changes to existing policies and procedures since the prior examination.

2. Copies of key MIS reports used to monitor the investment portfolio.

3. List of investment securities by held to maturity and available for sale designation, giving par, book and market values, and maturity dates.

4. List of pledged securities (par, book and market value).
5. List of purchases or sales of securities or other assets with either written or oral agreements to resell or repurchase.

6. List and description of any trades or contingency arrangements which could, in any way, move positions or transfer risk to/from the reporting entity to any related affiliates.

7. Identify any credit derivatives associated with the investment account.

8. A listing, including amounts, of all high risk mortgage-backed securities.

**Section 5 - Liquidity/Funds Management and Deposit Liabilities**

Please provide:

1. Copies of all key management reports used to monitor all aspects of liquidity and funds management.

2. Any new policies and procedures and changes to existing policies and procedures since the prior examination.

3. Details of sources of credit available to the organization. Identify any restrictions, if applicable.

4. List of the largest individual funding sources.

5. Details on lines of credit that are reciprocal between the lender and the bank.

6. Details on those entities which maintain compensating balances. Indicate any restriction placed on those accounts.

7. Details on unaffiliated borrowings of the consolidated organization.

8. List of the largest deposit balances aggregated by entity/related entities.

9. List of deposits by principal shareholders, directors, and executive officers of the bank by deposit type, amount, rate, origination date, and maturity date.

10. List of all brokered deposits including amount, rate, and maturity.
**Section 6 - Interest-Rate Sensitivity**

Please provide:

1. Copies of any new or revisions to existing policies and procedures for managing interest-rate sensitivity since the last examination, including methodologies, underlying assumptions, limit structure, and compliance.

2. Copies of all interest-rate sensitivity reports including scenario analyses used by management. Please include a repricing schedule/gap analysis which account for any hedged positions.

3. Copies of any audits performed regarding the asset/liability management process and/or interest rate sensitivity models.

4. Documentation for any interest rate risk models used. Specify major assumptions for each model (e.g. - prepayment speeds, core-deposit assumptions, deposit lag, and loan spreads).

5. Details on and results of any recent "stress" tests conducted.

6. Listing of off-balance sheet activities including interest rate futures, forwards, swaps, caps, collars, and floors. Also describe how these items are used to manage interest rate risk.

**Section 7 - Off-Balance-Sheet Items**

Please provide:

1. List of participations in this institution’s acceptances, letters of credit, and standby letters of credit conveyed to others.

2. List of participations in other institution’s acceptances, letters of credit, and standby letters of credit acquired by this institution.

3. List of other significant off-balance-sheet items, including:
   a) Securities lent,
   b) When issued securities (commitments to purchase and commitments to sell),
   c) Securities borrowed, and
   d) Other items.
4. The names of any individual or committee responsible for controlling and monitoring off-balance-sheet risks. In addition, supply copies of any key management reports used to evaluate/monitor these risks.

5. Any new or revisions to existing policies and procedures relating to the booking of off-balance-sheet commitments since the last examination.

**Section 8 - Auditing and Internal Controls**

The information requested in this area refers to audit and internal control material not specifically requested in other sections. Please provide a list of audit reports, with ratings, prepared since the previous examination promptly at examination commencement. Copies of specific audit reports will then be requested.

Please provide:

1. Information on the current year’s audit plan and schedule:
   a) Copy of the audit program and/or plan presented to the Audit Committee for the current year and any quarterly updates;
   b) All reports issued to the Board of Directors, Audit and/or Examining Committee, and senior management summarizing audit activities and findings since the last examination;
   c) If an outside C.P.A. firm or other organization provides audit services and/or assists at the annual directors’ examination, the firm's name, address, and contact person and copies of the most recent:
      - Audit report
      - Engagement letter
      - Management letter and reply

2. Description of audit planning and/or risk rating methodology used in preparing the annual audit schedule.

3. Description of the extent of audit coverage regarding any functions/activities which are out-sourced by the institution.

4. If a separate EDP Examination Questionnaire is not provided, list the name and location of each facility performing electronic data processing including off-premise servicers, and list the perspective applications processed. Provide a contact person for each application listed.
Please make available:

5. Minutes of the Examining and/or Audit Committee since the previous examination.

6. Internal risk assessments of significant business activities, if available.

**Section 9 - Bank Secrecy Act**

Please provide:

1. Copies of any new and revisions to existing policies and procedures, including those policies and procedures pertaining to compliance with the Office of Foreign Asset Control (OFAC) laws and regulations.

2. Make available operating manual(s) containing Bank Secrecy Act (BSA) procedures for branch office and teller operations.

3. A list of accounts for whom the bank does not have taxpayer identification numbers.

4. A copy of the most recent internal and external audit reports that relate to compliance with BSA, and management’s responses.

5. Make available a copy of the BSA training program.

6. Lists of exempt customers with which transactions are conducted.

7. Make available copies of (filed since prior examination):
   a) Currency Transaction Report (Form 4789),
   b) Currency & Monetary Instruments Report (Form 4790),
   c) Report of Foreign Accounts (Form 90-22.1), and
   d) Suspicious Activity Report (Form 2230).

8. If the bank offers Payable Through Accounts, provide a list of these accounts and describe monitoring procedures.
Section 10 - Loans to Executive Officers, Directors and Principal Shareholders
(See Regulation O for applicable definitions.)

Please provide the following for questions 1, 2, and 3:

<table>
<thead>
<tr>
<th>Borrower's Name</th>
<th>Present Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Endorser or guarantor</td>
<td>Repayment Terms</td>
</tr>
<tr>
<td>Date of Loan</td>
<td>Collateral Pledged and Market Value</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>Original Amount</td>
</tr>
<tr>
<td>Purpose</td>
<td>Date approved by the Board</td>
</tr>
</tbody>
</table>

1. List of direct and indirect extensions of credit by the bank, including overdrafts, to the following individuals and their related interests:

   a) Executive officers of the bank, of the holding company (if applicable), and of any of its subsidiaries;

   b) All other officers of the bank, bank holding company, or subsidiary of the bank holding company;

   c) Principal shareholders of the bank and the bank holding company;

   d) Directors of the bank, of the bank holding company, and of any subsidiary of the bank holding company; and

   e) Executive officers, directors, and principal shareholders of a correspondent bank.

2. List of direct and indirect extensions of credit by the bank or a correspondent bank to:

   a) The bank holding company and its subsidiaries (if applicable);

   b) Any company where the majority of directors also constitutes a majority of the directors of the bank or of the bank holding company; and

   c) Any other affiliate as defined by Section 23A of the Federal Reserve Act.

3. Loans by the organization to any borrowers secured by stocks, bonds, or other obligations of a related interest of a bank official.

4. Copies of required annual reports filed by executive officers and principal shareholders on indebtedness to this organization's correspondents (Form FFIEC 004).

5. List of the names and addresses of this organization's correspondent banks, as defined in Subpart B of Regulation O.
6. List of the bank’s investment in stocks, bonds, or other obligations of corporations in which bank officials are known to have a substantial interest.

Section 11 - Related Organizations

Please provide:

1. For new subsidiaries formed or acquired since the previous inspection, and changes, where applicable, on existing subsidiaries:
   a) Name,
   b) Location,
   c) Date acquired or formed,
   d) Percentage of ownership,
   e) Nature of business,
   f) Balance sheet and income statement for latest fiscal year and as of examination date,
   g) Off-balance-sheet activities,
   h) Management contact person, and
   i) List of officers and directors of subsidiary and affiliates.

2. For all subsidiaries, other than those under #1 above, a balance sheet and income statement for the latest fiscal year and current year to date.

3. List and describe: (a) services offered to any affiliate by the bank; (b) services offered to the bank by its subsidiaries/affiliates; and (c) services offered to customers of the bank by any subsidiaries or affiliates.

4. Identify any affiliate, as defined under Section 23A (b)(1) of the Federal Reserve Act. Indicate: (a) name and location; (b) nature of business as authorized by charter and as presently conducted; (c) manner of affiliation; (d) period of existence as such; (e) purpose of affiliation and circumstances under which it arose; and (f) number of shares of stock of bank owned or controlled and the number voted by each affiliate at last election of directors of the bank.
5. List (a) any loan or extension of credit to or for the benefit of an affiliate; (b) any investment in any securities, notes, or other assets acquired under a repurchase agreement, purchased from, or sold to an affiliate; (c) any investment in, or any loans or extensions of credit collateralized by capital stock, bonds, debentures, or other such obligations issued or guaranteed by an affiliate; and (d) any guarantees, acceptances, and letters of credit on behalf of an affiliate.

6. If any of the bank’s functions have been transferred to the bank holding company (if applicable), a holding company subsidiary or other bank affiliates since the previous examination, provide details.

7. Have any low quality assets (see Federal Reserve Act Section 23A(b)(10) for definition) been purchased or committed to be purchased by the bank from an affiliate? If so, provide details.

8. If the bank is a subsidiary of a bank holding company, has it extended credit or furnished services with the condition that the customer enter into a tie-in arrangement with any of its affiliates as defined in section 106(b) of the Bank Holding Company Act Amendments of 1970?

Section 12 - Miscellaneous

Please provide:

1. Provide a risk management policy or describe how risks (e.g. - credit, market, operational, liquidity, reputational, and legal) are identified, evaluated, monitored and controlled throughout the organization.

2. Analysis and documentation supporting the self assessment of payments system risk and evidence of review by the organization’s board of directors.

3. Copies of any written procedures for the selection and termination of correspondent relationships as well as the periodic review of correspondents’ financial condition. Please provide an assessment of the general rating criteria used by rating agencies whose evaluations are used in the selection, termination, or monitoring of correspondent relationships.

4. Policies and procedures relating to Regulation F and any supporting policies or sections thereof that may be referenced within the Regulation F policy.

5. A copy of the proxy statement.

6. A detailed schedule of fidelity bond and general liability insurance. The schedule should list in detail all areas covered for loss/liability.
7. Make available the bank’s latest quarterly litigation report describing any significant pending or threatened litigation or investigations against the organization or any director, officer, or policy-making employee in their official capacity; with the following information: a) name(s) of the plaintiff(s); b) nature of the claim and the damages requested; c) current status; and d) an opinion of the probable outcome of the litigation, including an estimation of the organization’s liability.

8. Description of and details on any new significant financial products or activities introduced/commenced since the prior examination. Describe the new products/activities approval process. Provide copies of any management reports regarding these products/activities.
ENTRY LETTER FOR

(3) BANK HOLDING COMPANY INSPECTIONS
THE FEDERAL RESERVE BANK
COVER LETTER FOR
BANK HOLDING COMPANY
INSPECTION QUESTIONNAIRE

In order to facilitate an inspection of (________) on a fully consolidated basis, you are requested to instruct the appropriate staff to provide the information described in this questionnaire. Unless indicated otherwise, information is requested as of the financial statement date (______________). You are asked to provide written responses to questions and copies of specific documents requested in this questionnaire only if the requested information is new or has changed since the previous inspection, which was conducted as of ________ (indicate no change where applicable). For each area covered by this questionnaire, please provide the most recent reports used by management to identify, measure, monitor, and control risk in the respective areas. Please note that examiners may make additional requests during the inspection.

Single copies of all submissions in response to the requests will be satisfactory unless otherwise indicated and should be delivered to the examiner-in-charge or designee. Any requests for clarification or definition of terms should also be directed to the examiner-in-charge.

In order to expedite the inspection, each completed schedule and other requested information should be submitted as soon as prepared and should not be accumulated for submission as a package. Please respond to every item in the questionnaire, indicating N/A if a question is not applicable.

Most of the requested data will not be needed until the commencement of the inspection, which is ________________. However, certain information may be needed earlier. Such information and the date due will be discussed with you.

______________________________  _____________________________
Federal Reserve Examiner-in-Charge    Telephone
Federal RESERVE BANK

BANK HOLDING COMPANY INSPECTION QUESTIONNAIRE

Please provide:

Structure

1. The most recent organization chart:
   a) For the holding company and its subsidiaries by legal entity showing percent
      ownership if less than 100 percent; and
   b) Of management by legal entity and functional business lines, if different, indicating
      lines of authority and allocation of duties for all key business lines and support
      areas of the organization.

2. List new activities that the bank holding company or nonbank subsidiaries, have engaged
   in since the previous inspection, either on or off-balance sheet, and identify the group
   responsible for the management of these activities. How has management identified and
   evaluated risk in relation to these new activities? Provide copies of any management
   reports regarding these products/activities. Please provide a copy of the company's risk
   policy statement regarding new activities.

3. The following on each new subsidiary formed or acquired since the prior inspection and
   changes, where applicable, on existing subsidiaries.
   a) Name,
   b) Location,
   c) Date acquired or formed,
   d) Percentage of ownership,
   e) Nature of business or business purpose,
   f) List of branch locations by city and state,
   g) Balance sheet and income statement,
   h) Off-balance-sheet activities and description of such,
   i) List of principal officers, and
   j) Management contact person.
4. Since (date) has there been any change in or transfer of functions or responsibilities between the corporation and its subsidiaries and between subsidiaries and/or their affiliates? If so, describe fully.

5. Since (date), have there been any sales or other transfers of any assets among the corporation and its subsidiary banks, affiliates of the banks, and/or other subsidiaries? If so, describe fully and include details on loan participations purchased and sold.

6. Since (date) have any subsidiaries been deactivated, sold, liquidated, transferred, or disposed of in some other way? If so, identify the subsidiary, the reason for disposition, and the effective date of disposition.

7. Has the corporation planned or entered into any new agreements written or oral to acquire any additional entities? If so, give pertinent details, including name, location, type of business, and purchase terms.

**Corporate Planning and Policy Information**

8. The latest financial projections or business plan(s) for revenues, expenses, assets, liabilities, capital, and contingent liabilities for the current and next fiscal years. Please include details on the assumptions used in the preparation of the projections.

9. A copy of the strategic business plan with updates or revisions, if any.

10. If new or amended since the prior inspection, copies of policies for the following:
   a) The level of supervision exercised over subsidiaries,
   b) Loans and investments of subsidiaries,
   c) Loan participations by and between subsidiaries,
   d) Dividends and fees from subsidiaries,
   e) Dividends paid to stockholders,
   f) Budgeting and tax planning for subsidiaries,
   g) Insider transactions,
   h) Funds management at the parent company and subsidiaries,
   i) Risk identification, evaluation and control,
j) Internal loan review and grading system, and
k) Internal audit.

**Corporate Financial Information**

11. For the consolidated company, provide consolidating balance sheet and income statement, including schedules of eliminating entries.

12. Full details on unaffiliated borrowings of the consolidated organization. For debt issued since the prior inspection, please provide the prospectus for public-debt offerings and a summary of terms for private-debt placements.

13. A copy of the most current periodic financial package prepared for senior management and/or directors.

**Subsidiary Information**

14. Consolidating and consolidated balance sheets, including off-balance-sheet items, and income statements for each nonbank first-tier subsidiary.

15. Details of all capital injections made to subsidiaries or returns of capital from subsidiaries (excluding normal operating dividends) since the prior inspection. Also provide details on any advance to a subsidiary which has been reclassified as equity.

16. If subsidiary banks have made any extensions of credit to the bank holding company and/or other affiliates, give details.

17. Describe any services performed by the parent for any subsidiaries or any company in which it has a 5 percent or greater interest.

**Parent Company**

18. Details on intercompany payments either (1) from the parent company to affiliates or subsidiaries or (2) from subsidiaries or affiliates to the parent company. Segregate into dividends, interest, management or service fees, expense payments, or other transfers made since the prior inspection. If a payment is governed by an intercompany agreement, please provide a copy of the agreement. If not, please provide the basis of the payment made.

19. Internally generated cash flow statement and liquidity schedule for the latest quarter ending. Make available supporting documentation. Provide access to the workpapers supporting the preparation of the Cash Flow Schedule from the Y-9LP report.
20. Full details on new parent company’s extensions of credit to and borrowings from subsidiaries (including unused lines of credit), since the previous inspection.

21. Full details on any third party credit lines made available since the previous inspection.

26. If any entities (parent company and/or subsidiaries) maintain compensating balances with third parties, indicate restrictions, if any.

27. A copy of the contingency funding plan. If such a plan does not exist, please provide a description of what actions would be taken to meet disruptions in the corporation’s short-term liability market.

28. Details on security investments held by type, par, book and market values, number of shares owned, interest rates, maturity dates, and convertibility features, where applicable.

29. For equity investments or any lending activity, please provide a listing with comments on any significant items that may not be fully collectable, and any other relevant factors.

30. If, since the previous inspection, the corporation has purchased or sold securities or other assets under an agreement to resell or repurchase, give details.

31. If the corporation has, for its own account, any incomplete purchases or sales of securities pending, give details.

32. If the parent corporation and/or any nonbank subsidiaries have loans outstanding secured by stock or any obligations of the corporation or any of its subsidiaries, give details.

33. If, since the prior inspection, the corporation, either for its own account or for others, has guaranteed the payment of any loan or other debt obligation or guaranteed the performance of any other undertaking, provide details.

**Corporate Debt-Markets Activities**

34. The following information on commercial paper:

   a) Direct placements outstanding,

   b) Dealer placements outstanding,

   c) Monthly maturity schedules showing breakdown for direct and dealer placements, and

   d) If the SEC has issued a "no action" letter, please submit a copy.
35. Identify any subsidiary which sells commercial paper for its own use or for its parent.

36. If any of the corporation’s or its subsidiaries’ commercial paper, stock, and/or convertible debt is held by trust departments of subsidiary banks provide details.

37. If there are any concentrations of commercial paper holdings in excess of 10 percent of the outstanding commercial paper by any individual or organization, provide details.

**Corporate Tax Information**

38. If the corporation files a consolidated tax return, on what basis does it determine the amount of taxes to be paid by subsidiaries? Provide a copy of the tax-sharing agreement with subsidiaries.

38. A schedule detailing the following information for \( \text{dates} \):

   a) Payments (estimated or otherwise) made by the corporate-tax-paying entity to the taxing authorities and the dates of such payments; and

   b) Payments received by the tax-paying entity from other holding company subsidiaries (or the tax benefits paid to those subsidiaries) and transaction dates.

39. Provide details of any ongoing IRS audit.

**Officers, Directors and Shareholders**

40. For senior officers of the corporation, indicate title and responsibility, and position(s) held at subsidiary and/or other organizations.

41. List of directors of the corporation and include:

   a) Number of shares owned directly and/or indirectly, and

   b) Occupation or principal business affiliation.

42. A brief biography of each senior officer appointed and director elected since the prior inspection. Please include the person’s date of birth, business background, education, and affiliations with any outside organizations. For senior officers indicate date of hire. For directors indicate date of election to board.

43. List of board committees, their memberships, and frequency of meetings.
44. Make available board and committee minutes.

45. Details on fees paid to directors.

46. If the corporation has entered into any contracts or agreements to pay or provide additional sums or fringe benefits to any director, officer or employee, provide cost and details.

47. Details on any stock option, incentive, bonus, or performance plans for officers and employees.

48. List of loans made by the parent company and/or nonbank subsidiaries to directors and executive officers (and their interests) of the parent company and/or subsidiaries. For the purpose of this request, a director's or executive officer's interest refers to a beneficial ownership, directly or indirectly, amounting to 25 percent or more; and also to companies otherwise controlled by a director or officer.

49. List of investments of the parent and/or subsidiaries in stocks, bonds, or other obligations of corporations in which directors and executive officers have a beneficial interest.

50. List of loans to any borrower secured by stocks, bonds, or other obligations of corporations in which directors and executive officers have a beneficial interest.

51. List of shareholders who own 5 percent or more of any class of voting stock and the percentage held.

52. List of loans made by the parent company and/or nonbank subsidiaries to shareholders who own 5 percent or more of the parent company's outstanding shares.

**Asset Quality**

53. A copy of the latest internal consolidated asset quality tracking report with aggregate totals of internally criticized assets and off-balance-sheet items. Identify aggregate exposures by type, risk rating, and entity where the exposure is booked. Distinguish between direct and indirect extensions of credit.

54. Details on consolidated loans past due as to principal and/or interest, nonperforming loans and other real estate owned, and totals of such for each subsidiary.

55. A breakdown of the corporation's consolidated and major subsidiaries loan loss reserves, including portions earmarked for the commercial, consumer, and other segments, with a description of and supporting data for the methodology used in determining its adequacy.
Audit

(Note: The following information should be requested only if the function resides within the parent company. If the function is performed at a nonmember lead bank subsidiary, then assess the audit function through discussions with the bank’s primary regulator.)

56. A copy of the most recent engagement letters or equivalent information which describes the scope of external audit activities performed for the corporation and any of its nonbank subsidiaries. Make available a copy of the audit program.

57. An organization chart which shows the structure and staffing of the audit function.

58. The following information about the auditor and key assistants (if not provided at prior inspections):

   a) Present position and date assumed,

   b) Date of employment, and

   c) Brief summary of education, experience at this institution, and prior work experience.

59. Make available the program and procedures used in conducting audits of the parent company and all subsidiaries.

Miscellaneous

60. A summary schedule of fidelity bond and general liability insurance, listing all areas covered for loss/liability, and date of board approval.

61. Make available the corporation’s latest pending litigation report describing any significant pending or potential litigation or investigations against the organization or any director, officer, or policy-making employee in their official capacity; with the following information:

   a) Name(s) of plaintiff,

   b) Nature of claim and damages requested,

   c) Current status, and

   d) An opinion of the probable outcome, including an estimation of the organization’s liability.
APPENDIX K

LOAN PORTFOLIO ANALYSIS
EXAMINATION MODULE
Internal Control and Audit

Analyze The Following Core Decision Factors

<table>
<thead>
<tr>
<th>Core Decision Factors</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the system of internal controls adequate?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the audit function independent with appropriate oversight from the board of directors?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the audit department adequately staffed with qualified individuals?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Has a satisfactory annual audit plan been developed in accordance with an appropriate risk assessment methodology?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the audit program adequate?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the external auditor’s role appropriate for the institution?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Does internal audit verify compliance with laws and regulations?</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Expanded Analysis
Evaluate the materiality of deficiencies and/or weaknesses with respect to the institution's condition.

Do Expanded Analysis Decision Factors indicate that risks are adequately managed?

For Core Decision Factors Answered Yes

Prepare appropriate report pages and comments.

For Core Decision Factors Answered No

Expanded Analysis

Perform Impact Analysis

Yes

No
The following Standards and Risks are provided to assist examiners in the review of Audit and Internal Controls. They are **NOT** intended to be all-inclusive. If necessary, examiners are encouraged to refer to examination/holding company manuals, SR letters, etc. 

**Note** - In examinations of the U.S. branches and agencies of foreign banking organizations (FBOs), references to "the board" in the discussion of Standards and Risks that follow should be construed to mean the head office management or, if applicable, the management of the regional or central unit located in the U.S. with overall responsibility for the FBO’s operations in this country.

<table>
<thead>
<tr>
<th><strong>STANDARDS</strong></th>
<th><strong>RISKS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Internal Control Systems</strong> --</td>
<td>Inappropriate actions or practices of employees could subject the institution to a variety of risks.</td>
</tr>
<tr>
<td>Policies such as codes of conduct, acceptable business practices, and conflicts of interest exist and are followed.</td>
<td>Undesirable behavior may result.</td>
</tr>
<tr>
<td>Management’s actions clearly demonstrate and communicate the importance of integrity and ethical values throughout the organization.</td>
<td>Institution may be exposed to reputational risk.</td>
</tr>
<tr>
<td>Management takes appropriate actions regarding the intervention or the overriding of established controls.</td>
<td>Violation of law may occur.</td>
</tr>
<tr>
<td>The board and its committees constructively challenge management decisions and scrutinize activities.</td>
<td>Circumvention of controls could result in unexpected losses.</td>
</tr>
<tr>
<td>The board meets with chief financial and/or accounting officers, internal auditors, and external auditors on a frequent and timely basis.</td>
<td>Lack of independence from management hinders objective decision making.</td>
</tr>
<tr>
<td>The board or its committees are provided with appropriate information on a frequent and timely basis to facilitate monitoring management’s objectives and strategies; and the institution’s financial position and operating results.</td>
<td>Ineffective oversight could result in a poor internal control environment with a high probability of operating losses.</td>
</tr>
<tr>
<td>Reporting relationships facilitate the flow of information necessary for effective internal controls.</td>
<td>Insufficient information leads to ineffective oversight.</td>
</tr>
<tr>
<td>Management conducts risk assessments to identify key business risks.</td>
<td>Inappropriate reporting lines may impede effective communication.</td>
</tr>
</tbody>
</table>

**Independence and Board Oversight** --

<table>
<thead>
<tr>
<th><strong>STANDARDS</strong></th>
<th><strong>RISKS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A clear reporting line to the board exists.</td>
<td>Management may have undue influence on the auditor.</td>
</tr>
<tr>
<td>The general auditor’s compensation, performance evaluation, and department budget should be approved by the audit committee and the board.</td>
<td>Sufficient resources may not be available to complete the audit plan and the auditor’s independence may be compromised.</td>
</tr>
<tr>
<td>STANDARDS</td>
<td>RISKS</td>
</tr>
<tr>
<td>-----------</td>
<td>-------</td>
</tr>
<tr>
<td>Audit department staff should not have operational responsibilities.</td>
<td>The potential exists for conflict of interest.</td>
</tr>
<tr>
<td>The audit committee should be comprised of outside directors with appropriate business backgrounds.</td>
<td>Significant issues and risks may be overlooked or misunderstood.</td>
</tr>
<tr>
<td>Significant deficiencies/issues should be reported to the audit committee and board.</td>
<td>The audit committee and board may not be informed of audit identified deficiencies or internal control weaknesses.</td>
</tr>
<tr>
<td><strong>Staff Qualifications</strong> --</td>
<td></td>
</tr>
<tr>
<td>Auditors should have related experience and/or academic and professional certification.</td>
<td>Auditors may not understand the issues and risks.</td>
</tr>
<tr>
<td>The general auditor should have a commitment to continuing education and training.</td>
<td>Audit needs to remain current with latest industry trends and techniques.</td>
</tr>
<tr>
<td><strong>Annual Plan and Risk Assessment</strong> --</td>
<td></td>
</tr>
<tr>
<td>The audit universe needs to be identified and auditable entities need to be assigned an appropriate risk grade.</td>
<td>Areas or functions may not be subject to review.</td>
</tr>
<tr>
<td>An annual audit plan should be developed based on the risk assessment.</td>
<td>Areas of high risk or exposure may be inappropriately prioritized.</td>
</tr>
<tr>
<td>The annual plan should be approved and monitored by the audit committee.</td>
<td>Sufficient time and resources may not be devoted to the audit process.</td>
</tr>
<tr>
<td><strong>Audit Program</strong> --</td>
<td></td>
</tr>
<tr>
<td>Written policies and procedures exist.</td>
<td>Inadequate policies and procedures may expose the institution to greater internal control risk.</td>
</tr>
<tr>
<td>Audit reports are issued in a timely fashion and require management response.</td>
<td>Unreported exposure may continue to exist and management may disagree with findings.</td>
</tr>
<tr>
<td>Significant exposures are tracked.</td>
<td>Failure to correct deficiencies may result in increased exposure.</td>
</tr>
<tr>
<td>Audit work is adequately documented.</td>
<td>Inadequate documentation impedes proper review of risk.</td>
</tr>
<tr>
<td>Ability to adapt to changes in new technology.</td>
<td>Audit methods and procedures may become outdated or ineffective.</td>
</tr>
<tr>
<td></td>
<td>Staff may lack necessary expertise.</td>
</tr>
<tr>
<td>STANDARDS</td>
<td>RISKS</td>
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</tbody>
</table>
| - Timely recognition of new auditable entities, structure changes, and management turnover. | - Potential risk of new products and activities are not identified.  
- Change is an indicator of potential risk. |
| **Role of External Auditor** --  
- The institution’s certified public accountant is registered or licensed to practice public accounting and in good standing with the appropriate state and/or regulatory agency. | - Violation of regulatory statutes. |
| - The certified public accounting firm is independent. | - Conflicts of interest may result. |
| - Outsourced or co-sourced work should meet internal audit standards. | - Inadequate review may result.  
- Required audit department standards may not be met. |
| - CPA attestation reports are prepared. | - Violation of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). |
| **Compliance with Laws and Regulations** --  
- The institution complies with all laws and regulations. | - Violations could result in costly penalties and increased supervisory oversight.  
- Regulators, shareholders, and customers lose confidence in the institution and its management. |
| **Information Systems** --  
- Information systems supporting executive decisions are effective, accurate, timely, and well-controlled. | - Business decisions are based on incomplete, outdated, or inaccurate information.  
- Inappropriate design and implementation of management information systems impedes the ability of directors and management to monitor risks within the institution.  
- Technology is inconsistent and not supportive of business needs |
Consider the following procedures at each examination/inspection. Examiners are encouraged to continue to exercise discretion in excluding items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination/inspection. The references are not intended to be all-inclusive and additional guidance exists. **Many of these procedures will address more than one of the preceding standards and risks.** For the examination/inspection process to be successful, examiners must maintain open communications with management and discuss relevant concerns as they arise. **Note -** In examinations of the U.S. branches and agencies of foreign banking organizations (FBOs), references to “the board” in the decision factors that follow should be construed to mean the head office management or, if applicable, the management of the regional or central unit located in the U.S. with overall responsibility for the FBO’s operations in this country. FBOs are expected to provide a level of oversight and management involvement in their U.S. operations to meet the standards addressed in the Standards and Risks section of this module.

## INTERNAL CONTROL SYSTEMS --- Is the system of internal controls adequate?

The control elements detailed below are structured in accordance with the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) requirements.

### Control Environment

Management should convey a clear message to employees through policies, procedures, or practices, that integrity and ethical values are an integral part of the institution’s culture and cannot be compromised.

1. Determine that management has established a comprehensive written code of ethics/conduct.
2. Ensure that an appropriate procedure exists to communicate the code to employees.
3. Ensure management has established the necessary mechanism to monitor compliance.
4. Verify that the auditor or a member of the audit staff participates in appropriate executive and operations’ committees, or has access to the committees’ minutes.

### Control Activities

The board or committees of the board should provide effective oversight. Policies and procedures regarding the system of internal controls should minimize employee ability to override the systems.

1. Coordinate with other examiners responsible for completing modules included in the examination/inspection scope to ensure that control activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, and segregation of duties, etc. are in place and authorized.
2. Emergency Preparedness/Disaster and Business Recovery
   a. Obtain the bank’s written instructions regarding appropriate reaction to emergency situations.
### CORE ANALYSIS

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<tbody>
<tr>
<td>b.</td>
<td>Determine that instructions are up-to-date and reflect the current operating environment.</td>
</tr>
<tr>
<td>c.</td>
<td>Determine how management identifies operations critical to the organization.</td>
</tr>
<tr>
<td>d.</td>
<td>Obtain the results of the latest test of the various business recovery plans and determine whether the test was &quot;successful&quot; in meeting stated test objectives.</td>
</tr>
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</table>

3. **Vacation Policy**

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<tbody>
<tr>
<td>a.</td>
<td>Determine that the institution has established a vacation policy in accordance with SR 96-37 and that it is adequately monitored.</td>
</tr>
</tbody>
</table>

### Risk Assessment

This process should consider external and internal factors that could impact achievement of the organization’s strategic plan and should identify and analyze risks, and provide a basis for managing and reacting to changing conditions.

1. Ensure that management conducts risk assessments.

<p>| | |</p>
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<tbody>
<tr>
<td>a.</td>
<td>Determine that risks are appropriately managed.</td>
</tr>
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</table>

2. Ensure that the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) Section 112 requirements are met, such as the filing of management and CPA attestation reports.

### Information and Communication

Pertinent information must be identified, captured, and communicated in a form and timeframe that enable employees to fulfill their responsibilities.

1. Review whether management information systems are in place to identify and capture relevant internal, as well as external information.

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<tbody>
<tr>
<td>a.</td>
<td>Determine if the systems are adequate in the higher risk areas.</td>
</tr>
<tr>
<td>b.</td>
<td>Determine if the institution has ongoing review of the information systems for accuracy.</td>
</tr>
</tbody>
</table>
**Monitoring**

Appropriate procedures must be in place to periodically evaluate internal controls, report deficiencies to appropriate members of management and the board, and modify policies and procedures as needed.

1. Determine if appropriate procedures are in place to monitor on an ongoing basis and evaluate the internal control system. This may include self-assessments.

**COMMENTS**
INDEPENDENCE AND BOARD OVERSIGHT -- Is the audit function independent with appropriate oversight from the board of directors?

1. Determine whether the audit department is functionally segregated from operations, and that auditors are not performing operational tasks.

2. Ensure that the audit committee reviews and/or approves the budget, salary, and performance evaluation of the general auditor.

3. Determine if the board has delegated responsibility for the audit function to an audit committee of outside directors, with appropriate business backgrounds.

4. Verify that the audit committee meets with the auditor and reviews audit findings with appropriate frequency.

5. Ascertain that bank personnel are not actively involved in audit committee meetings.

6. Review the minutes of the audit committee to determine an appropriate interest exists in the activities and findings of the auditor.

7. Ensure appropriate controls are in place if internal auditors borrow from the institution.

COMMENTS
STAFF QUALIFICATIONS -- Is the audit department adequately staffed with qualified individuals?

1. Determine whether the auditor and audit staff hold professional designations, such as certified public accountant, certified bank auditor, certified information system auditor.

2. Evaluate the ability of the auditor and audit staff to communicate and relate well with all levels of personnel.

3. Are members of the staff experienced in specialized areas, e.g., management information systems (MIS), capital markets, trust, subsidiary activities of the institution, etc.?

4. Ensure there is an audit training program, and verify that it includes the latest developments in banking and auditing technology and specialized training for areas such as MIS, capital markets, trust, etc.

5. Assess the level of audit personnel turnover and vacancies, and ascertain the cause of any trends.

COMMENTS
ANNUAL PLAN AND RISK ASSESSMENT -- Has a satisfactory annual audit plan been developed in accordance with an appropriate risk assessment methodology?

**Risk Assessment**

1. Evaluate the written policies and procedures that document the risk assessment process. Ensure that risks inherent in operations and compensating control mechanisms are considered.

2. Determine that all auditable units are identified and associated risks are documented.

3. Sample selected auditable units, validate their assigned risk ratings, and determine if the frequency of review is commensurate with the risks.

4. Ensure that audit unit reviews are completed within the identified risk cycle.

5. Verify that risk assessments are updated and approved annually by the board.

**Annual Plan**

1. Ensure that a formalized audit plan has been approved by the audit committee/board.

2. Determine that the plan includes all significant functions, activities, and services.

3. Ensure that the plan is periodically reviewed and updated by the internal audit department.

4. Determine progress against the annual audit plan and ensure that significant changes are approved by the audit committee/board.

5. Ensure the scope and frequency schedule comply with statutory requirements.

**COMMENTS**
# CORE ANALYSIS

**AUDIT PROGRAM** -- Is the audit program adequate?

<p>| | |</p>
<table>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Ensure MIS provide timely and accurate information to manage the audit function.</td>
</tr>
<tr>
<td>2.</td>
<td>Review written policies, procedures, and/or the audit manual(s) for adequacy.</td>
</tr>
<tr>
<td>3.</td>
<td>Ensure a documented method exists to assure audit management that a proper study and evaluation of existing internal controls was completed (such as, internal control questionnaires or memoranda.)</td>
</tr>
<tr>
<td>4.</td>
<td>Determine the audit function’s rating criteria for audit reports and evaluate them for reasonableness.</td>
</tr>
<tr>
<td>5.</td>
<td>Review all audit reports and responses since the previous examination/inspection that were rated less than satisfactory. Also review reports submitted to the board/audit committee and summarize significant issues or major areas of concern.</td>
</tr>
<tr>
<td>6.</td>
<td>Review selected audit programs for adequacy.</td>
</tr>
<tr>
<td>7.</td>
<td>Determine the effectiveness of the audit reporting system regarding distribution, time frames for issuance and response, format, and follow-up procedures.</td>
</tr>
<tr>
<td>8.</td>
<td>Review the overall audit manual(s) to determine the general sufficiency of prescribed procedures for the accomplishment of the department’s stated objectives.</td>
</tr>
<tr>
<td>9.</td>
<td>Determine the standards employed to test (i.e., statistical, analytical, judgmental, percentage, etc.) various types of records and transactions to ensure that internal audit employs reliable testing methods.</td>
</tr>
<tr>
<td>10.</td>
<td>Evaluate the standards for maintenance of workpapers to ensure they provide adequate support for the execution of audit procedures’ tests performed, calculations employed and disposition of findings.</td>
</tr>
<tr>
<td>11.</td>
<td>Using a sample of internal audit’s workpapers, evaluate the completeness of the audit findings by randomly testing the execution of the audit program to ensure that all exceptions were identified during the audit review.</td>
</tr>
<tr>
<td>12.</td>
<td>Ensure a formal process exists for updating audit procedures to reflect changing conditions.</td>
</tr>
<tr>
<td>13.</td>
<td>Ensure that the audit department includes the following miscellaneous areas in its risk assessment process and provides appropriate coverage:</td>
</tr>
<tr>
<td></td>
<td>a. Code of ethics;</td>
</tr>
<tr>
<td></td>
<td>b. Dormant accounts;</td>
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</tbody>
</table>
c. Return mail/hold mail;
d. Due from banks;
e. Employee accounts;
f. General ledger, reconciliation, and interoffice clearing accounts;
g. Negotiable instruments;
h. Off-balance-sheet accounts; and,
i. Overdrafts and payments against uncollected funds.

Note: If coverage is not deemed appropriate, consider supplementing the coverage or requiring that the institution have internal or external audit review the area.

14. Determine that the audit department is involved in reviewing new system projects and major operational procedure changes or modifications.

15. Verify direct verification programs are used for appropriate assets, liabilities, and off-balance-sheet activities.

16. Ensure service-related activities not specifically included in general ledger accounts are subject to adequate periodic review, such as regulations, security, vacation policy, securities purchases, safekeeping, etc.

17. On a test basis, ensure all significant and/or unresolved exceptions noted in the workpapers are included in the audit report.

18. Ensure audit reports:
a. Adequately reflect the scope of the audit;
b. Contain an opinion regarding the adequacy, effectiveness, and efficiency of internal controls;
c. Provide recommendations, where applicable, to correct deficiencies; and,
d. Require a prompt response.

19. Determine if a formal audit-comment-tracking system is in place for significant exposures.

20. Ensure exceptions and recommendations are generally resolved in a timely manner.

21. Determine if audit reports are issued in a timely manner. (Best practices -- within 30 days of completing audit fieldwork.)
22. Ensure written responses are included in the audit report or required from the appropriate level of management within a reasonable time period (usually two weeks.)

COMMENTS
<table>
<thead>
<tr>
<th>ROLE OF THE EXTERNAL AUDITOR -- Is the external auditor’s role appropriate for the institution?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ensure the certified public accountant (CPA) is independent from the management, operations, and business dealings of the institution.</td>
</tr>
<tr>
<td>2. Determine the CPA has been subjected to an acceptable peer review and the peer review report has been filed with the FDIC.</td>
</tr>
<tr>
<td>3. Ensure the CPA provided the institution all necessary attestation reports required by FDICIA.</td>
</tr>
<tr>
<td>4. Determine the CPA has met with the institution’s audit committee to review reports prepared by management.</td>
</tr>
<tr>
<td>5. Determine if an external auditor has been engaged to perform special reviews of specific departments or areas of the institution since the previous examination/inspection, and if deficiencies were cited, have they been corrected?</td>
</tr>
<tr>
<td>6. If independent contractors are employed to perform audits to replace or supplement internal audit coverage review supporting work papers to ensure coverage meets the same minimum standards set forth for internal audit.</td>
</tr>
<tr>
<td>7. Review the most recent engagement letters covering the activities of CPAs and/or consulting firms that have been engaged for statement certification, operational reviews, or appraisal of the internal audit function.</td>
</tr>
<tr>
<td>8. If CPAs are employed by the institution’s board to certify financial statements and/or attest to the adequacy of internal controls for compliance with Section 112 of FDICIA, determine from the engagement letters and/or reports, that the scope of their review is sufficient to render the necessary affirmations.</td>
</tr>
</tbody>
</table>

   If these sources are not deemed adequate to assure the necessary coverage, consideration should be given to obtaining the supporting work papers from the CPAs to determine the adequacy of the work performed in rendering the opinions. |

| 9. If there has been a change in independent contractors employed to prepare regulatory reports and render statements as to the adequacy of financial statements and internal controls, determine that records sufficient to determine the reason for the change are available as required by Section 112 of FDICIA. |

**COMMENTS**
COMPLIANCE WITH LAWS AND REGULATIONS -- Does internal audit verify compliance with laws and regulations?

1. Ensure the audit program includes procedures necessary to assure compliance with all applicable banking laws and regulations, such as FDICIA, The Bank Secrecy Act, Section 20 of The Banking Act of 1933, and Section 23A&B of the Federal Reserve Act, etc.

COMMENTS
### Core Analysis

**INFORMATION SYSTEMS** -- Do technology and automated processes support information needs and decision making?

**Effective Use and Control of Information**

1. Determine that information technology (IT) plans and budgets are consistent with audit’s mission and plans.
   
   a. Ensure that audit staff has the expertise and ability to manage and control its technology and automated processes, including associated risks.
   
   b. Determine that audit’s needs and objectives drive the development or purchase of new applications in coordination with technical and audit staff.
   
   c. Verify that, where appropriate, audit systems and technology are functionally compatible throughout the organization and adequately support business objectives.
   
   d. Ensure that the board of directors, audit committee members, managers, and audit personnel receive timely and accurate information that is necessary to make informed decisions.

2. Determine that audit management retains ultimate responsibility for their IT and associated risks.
   
   a. Determine that audit management has identified potential vulnerability, including possible security weaknesses, in audit data and systems and actively monitors such risks.
   
   b. Verify that audit management is ultimately responsible for and complies with information and data security policies, identifies areas of security risk, is responsible for the design, implementation, testing, and monitoring of those areas, including taking the necessary corrective action when deficiencies are identified.
   
   c. Determine that service provided by third parties meet all internal security standards and that security controls maintain a logical separation of authority with automated applications.
   
   d. Determine that a contingency plan has been developed that ensures business continuity and is periodically tested and updated.
   
   e. Verify that audit information necessary to make informed decisions can be consistently delivered to users, e.g., board of directors, senior management, audit management, regulators on a timely basis.
**CORE ANALYSIS**

| f. | Ensure that audit management is vigilant as to the quality and accuracy of data supporting audit activities and the tools upon which it relies by assuring appropriate testing procedures and change controls for new or modified applications. |

**Audit’s Review of the Institution’s Information Technology**

1. Determine that internal audit adequately reviews the institution’s IT and associated risks.
   
a. Ensure that audit staff has the expertise and ability to evaluate the institution’s technology and automated systems, including associated risks.

b. Determine that audit staff appropriately reviews the documentation of the institution’s systems, and fully documents such review in audit workpapers.

c. Ensure audit is appropriately involved in the development of new systems and modification and conversion of old systems.

d. Determine if audit software is appropriately used as investigative tools, and that the reliability of these tools are understood and documented.

e. Ensure that audit identifies potential security weaknesses in the institution’s data systems, including violations of information and data security policies, and performs appropriate follow-up.

f. Determine that audit coverage extends to third party vendors and service providers.

g. Determine that audit is appropriately involved in the institution’s System Development Life cycle (SDLC) including testing and change control procedures.

h. Ensure that audit reviews the institution’s contingency and business resumption plans, including file rotation and retention, and vital records, and its ability to conduct business concurrently with recovery.

i. Ensure that audit verifies that systems and technology are functionally compatible throughout the organization and adequately support business objectives where appropriate.

j. Determine that audit reviews the institution’s systems to ensure that data necessary to make informed decisions can be consistently delivered to users on a timely basis.

k. Determine that audit staff assesses the quality and accuracy of information supporting business activities and the accuracy of the technological tools used to provide the data.
CORE ANALYSIS

1. Verify that audit staff evaluate the accuracy and reliability of models used by business units to manage risks.

COMMENTS
# CORE ANALYSIS DECISION FACTORS

Evaluate Core Analysis results in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may **NOT** require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision Factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate. Examiners are expected to fully document their conclusions.

1. Is the system of internal controls adequate?
2. Is the audit function independent with appropriate oversight from the board of directors?
3. Is the audit department adequately staffed with qualified individuals?
4. Has a satisfactory annual audit plan been developed in accordance with an appropriate risk assessment methodology?
5. Is the audit program adequate?
6. Is the external auditor’s role appropriate for the institution?
7. Does internal audit verify compliance with laws and regulations?
8. Do technology and automated processes support information needs and decision making?

**Report of Examination/Inspection Presentation**

*Discuss analyses, conclusions, and recommendations with the EIC and the examiners assigned to develop/verify regulatory ratings for the following report pages:*

**Examinations**

1. **Management**: Assess audit activities’ impact on the overall management rating.
2. **Risk Management Assessment**: Detail significant deficiencies regarding audit’s policies, procedures, and planning, as well as the depth and adequacy of its reviews and risk assessments, etc.

**Inspections**

1. **Managerial Composite**: Assess audit activities’ impact on the managerial composite rating.
2. **Audit page**: Detail significant deficiencies concerning audit’s policies, annual plan, risk assessments, appropriateness of board oversight, etc.

**COMMENTS**
EXPANDED ANALYSIS

Generally, target procedures in this section should address concerns identified in the Core Analysis and Decision Factors. Exercise the same flexible guidelines specified in the Core analysis section. The questions may be addressed either individually or within an overall comment.

1. Consider expanding testing in selected areas.

2. Consider requiring that additional testing be performed by the internal auditors or a CPA firm.

3. Refer exposures noted during the examination/inspection process or noted by the internal/external auditors to the appropriate examiner(s) for follow-up during the examination/inspection.

COMMENTS
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<tr>
<th>Question</th>
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<tbody>
<tr>
<td>1. Are audit department deficiencies immaterial?</td>
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<tr>
<td>2. Does the audit department effectively oversee the operations of the</td>
</tr>
<tr>
<td>institution?</td>
</tr>
<tr>
<td>3. Are deficiencies in audit policies and procedures, activities, or</td>
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<tr>
<td>internal controls easily corrected or insignificant?</td>
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<tr>
<td>4. Are audit testing procedures adequate?</td>
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<td>5. Are audit risk assessments, scopes, reports, and review frequencies</td>
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<td>adequate?</td>
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<tr>
<td>6. Are new activities and/or new entities being incorporated in the</td>
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<td>audit plan and risk assessment?</td>
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**Report of Examination/Inspection Presentation**

*Discuss analyses, conclusions, and recommendations with the EIC and the examiners assigned to develop/verify regulatory ratings for the following report pages:*

1. Those addressed in the Core Analysis section.
2. Supplemental pages as needed.

**COMMENTS**
### IMPACT ANALYSIS

This section helps to evaluate the impact of deficiencies identified in the Core and Expanded Analyses and Decision Factors on the institution’s overall condition. This section also directs the examiner to consider possible supervisory actions.

1. Determine the impact of the annual plan not being completed, taking into consideration high risk areas not reviewed.

2. Determine the impact of a loss of independence in the audit department.

3. Determine the need for enforcement actions. Formulate specific recommendations, and advise Reserve Bank management and Board staff on the nature of the supervisory concerns.

### COMMENTS
APPENDIX L

LISTING OF COMMUNITY BANK EXAMINATION MODULES
LISTING OF
COMMUNITY BANK EXAMINATION MODULES

PRIMARY MODULES

Capital Adequacy Analysis
Loan Portfolio Management
Management and Internal Control Evaluation
Earnings Analysis
Liquidity Analysis
Securities Analysis
Other Assets and Liabilities

SUPPLEMENTAL MODULES

Electronic Funds Transfer Risk Assessment
Mortgage Banking
Related Organizations
International Banking
Credit Card Related Merchant Activities
Electronic Banking

LOAN REFERENCES

Construction and Land Development
Commercial and Industrial Real Estate
Residential Real Estate Lending
Commercial and Industrial Loans
Agricultural Lending
Direct Lease Refinancing
Floor Plan Loans
Troubled Debt Restructuring
Consumer and Check Credit
Credit Card Activities